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Commodities grow more appealing

By Sophia Grene

The most striking story in this year's FTfm/Towers Watson survey of alternative investment managers looking after pension fund money centres on commodities: the level of pension fund assets accounted for by commodities managers among the top 100 managers tripled in 2009. There are now five such managers in the top 100, compared with just one in 2008 (PDF of top 20).

Framed differently, the story is a little less compelling, as this is from a low base. Pension fund assets allocated to commodities within the top 100 managers have risen from 0.4 per cent to 2 per cent.

Even now, pension fund assets managed by the 22 commodities managers who responded to the survey are just $28bn (£18.5bn, €22bn), or 3 per cent of the total $894,243m of pension fund assets managed by the 149 fund managers (224 entries as some groups manage assets in more than one area) the survey covers.

But this is a meaningful trend, according to Alasdair MacDonald, a senior investment consultant at Towers Watson, and one he expects to continue.

Pension funds are taking advantage of the collapse in commodity prices that followed the financial crisis to gain exposure to the asset class at an attractive level, Mr MacDonald says.

"Given that pension funds are slow movers, you will continue to see allocations in 2010," he predicts.

Investment in commodities is not necessarily a vote of confidence that their prices will rise, of course. Commodity hedge funds, for example, make money in the liquid and fast-moving commodities futures markets by exploiting small, short-term movements up or down and aim to deliver positive returns regardless of market prices.

This kind of investment in commodities is not showing up in the survey, however, although it is possible there are such investments within the funds of hedge funds. Instead, the types of managers appearing in the top 100 show pension funds putting their money

with large managers looking for market returns.

The top five commodities managers for pension funds are Pimco, Gresham Investment Managers, Schroders, Diapason and Hermes. Just two of these are commodities specialists – Gresham and Diapason – neither is a market-neutral player, so it is reasonable to assume pension funds see commodities as a strategic allocation rather than an opportunity for alpha.

The attraction of commodities lies largely in expectations about how they will behave in relation to other assets or in particular situations.

"Clients are mainly going in to get exposure to the beta, to get some of the nice characteristics of commodities," Mr MacDonald says. While diversification is a key characteristic attracting investors, he warns "it is easy to overstate the diversification benefit".

More to the point, he thinks, are "some nice tail-hedges, such as if tensions rise in the Middle East". A geopolitical crisis in the region would probably lead to higher oil prices, so investors concerned about the impact on equities would have the consolation of making money on the commodities investment.

On the whole, pension funds are taking a broad approach, asking managers to manage assets against broad indices rather than specific commodities or commodity sectors.

"They want to have as broad an exposure to commodities as possible," Mr MacDonald adds. "It's not possible for a pension fund to take a view on individual commodity classes."

The exception to this rule is Diapason, which has a particular interest in agricultural commodities.

One notable aspect of pension funds' allocations to commodities is the concentration in the top managers. The top five account for more than 70 per cent of the assets managed for pension funds by the top 20 managers, with the next 10 adding a further 28 per cent. Smaller managers scraped up just 1 per cent of assets between them.

This is to be expected, Mr MacDonald explains, as "we look at commodities as a semi-passive allocation" because the main benefit of the asset class is the diversification for a portfolio, rather than the outperformance of a single manager.

Where manager skill is not the primary objective, economies of scale can become a differentiator. This can result in the market being dominated by a small number of large players. However, since commodities can offer alpha opportunities, small players may thrive on the sidelines, but they may not be able to deal with larger pension funds due to capacity constraints.

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