

STRUCTURAL SOURCES OF RETURN IN COMMODITY FUTURES INVESTMENTS

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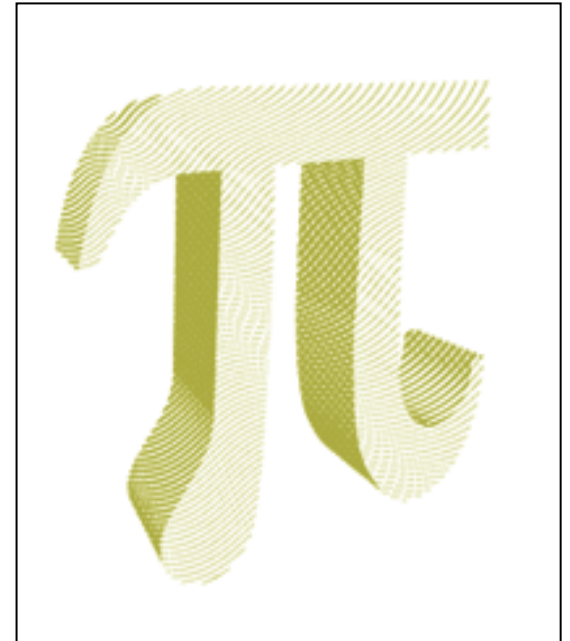
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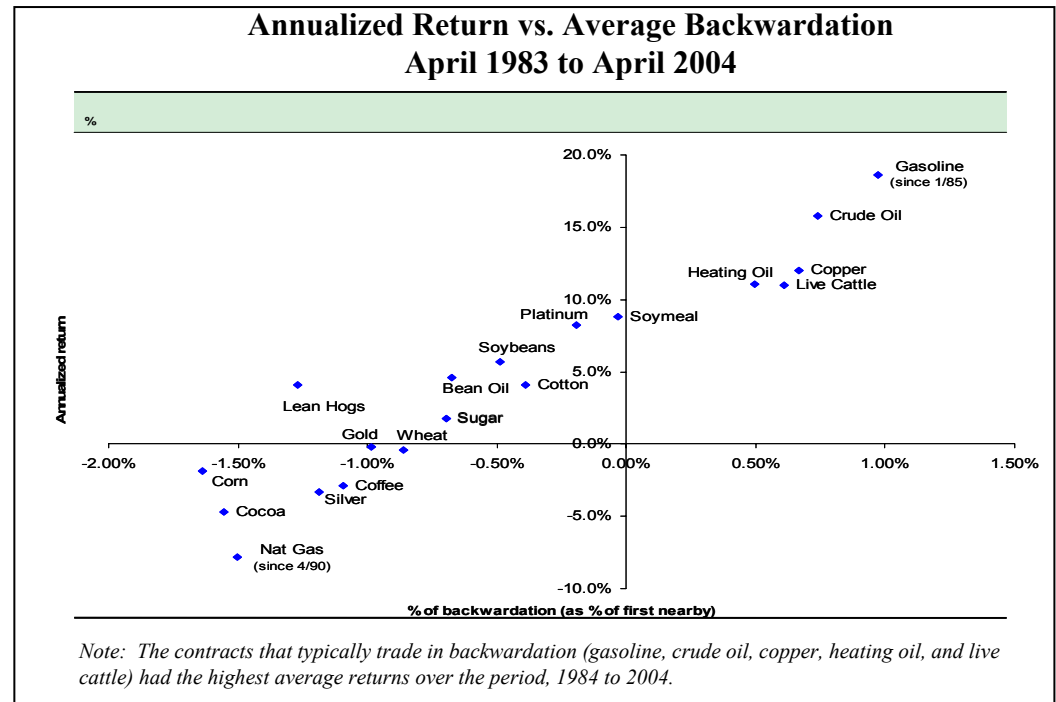
I. Rebalancing

- **Erb and Harvey (2006) show mathematically that “...when asset variances are high and correlations are low,” the diversification return from rebalancing can be high.**
- **The rebalancing effect has also been explored by Greer (2000).**
- **This return is separate from any returns due to each individual commodity within the index.**



II. Term Structure

- **Over very long timeframes, a number of authors have shown how the term structure of a commodity futures curve has been the dominant driver of returns in futures investing.**
- **Over a single 21-year timeframe, the returns of a commodity futures contract have been linearly related to how backwardated the contract has been.**

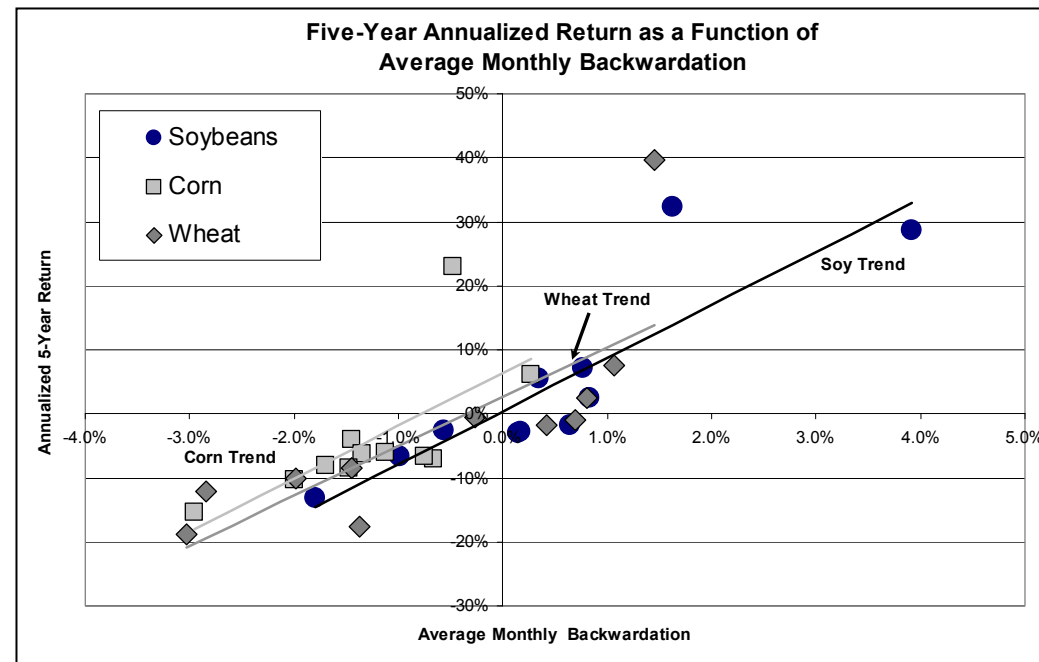


II. Term Structure (Continued)

Feldman and Till (2006) find that the power of backwardation to explain commodity futures returns is indeed valid but requires a *long* investment time horizon.

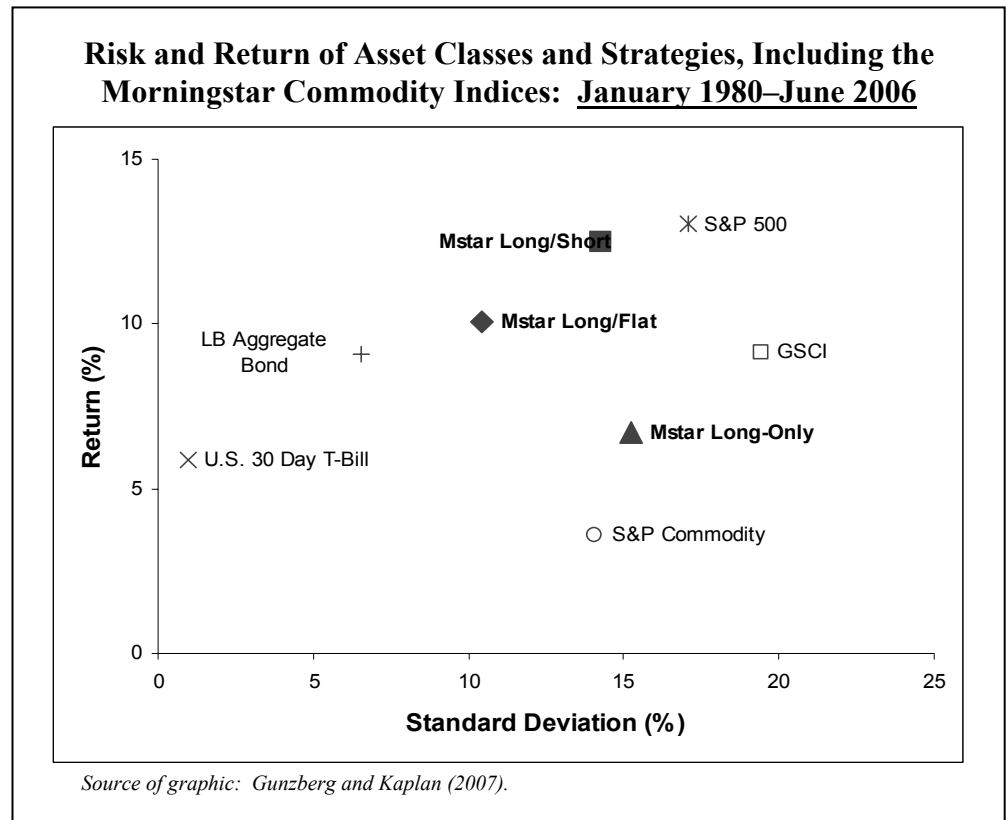
- We examined the soybean, corn, and wheat futures markets over the period, 1950 to 2004.

- Extending the evaluation period to five years, the average level of backwardation explains 64% of the variation in futures returns.



III. Short-Term Momentum

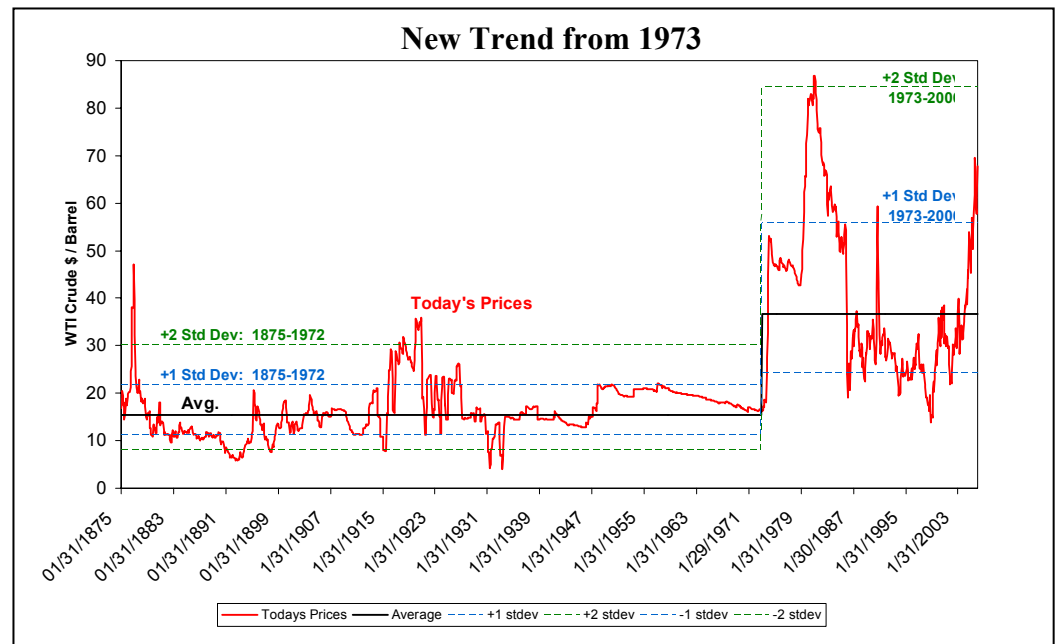
- **When there is a supply/usage imbalance in a commodity market, the price trend may be persistent, which, in turn, systematic long/short trend-following systems may be able to capture.**



IV. Rare Trend Shifts

The 1970's Revisited

- There can be an additional fundamental rationale for a long-term passive investment in a commodity futures contract besides structural backwardation, and ...
- ... that is that one expects the factors are in place to repeat the early 1970's experience.



References

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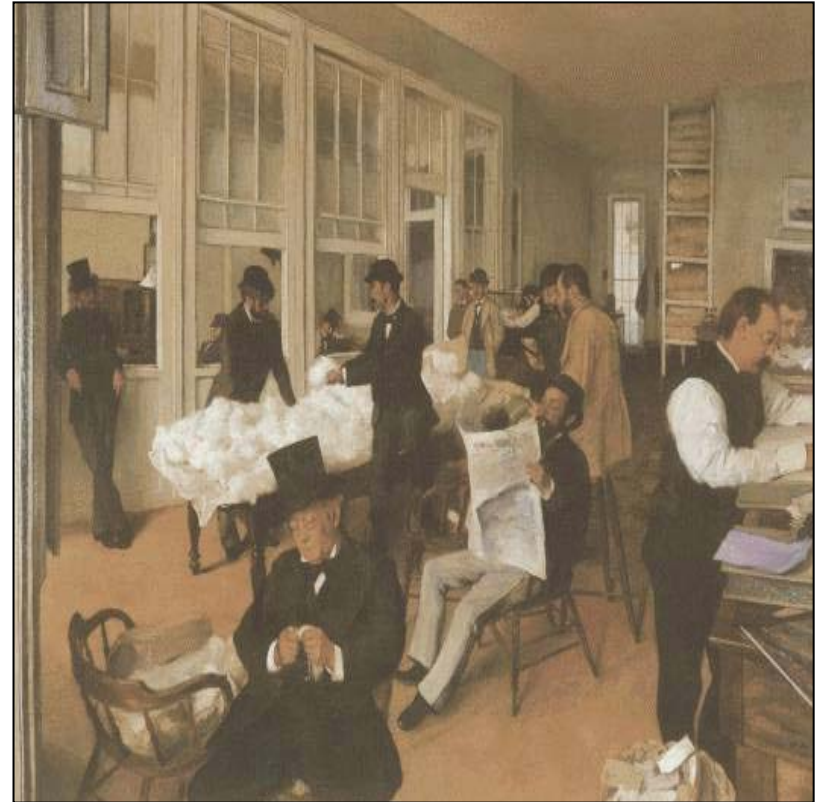
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Source of graphic: Degas, Edgar, "The Cotton Exchange at New Orleans," 1873, Musée Municipal, Pau, France.

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