

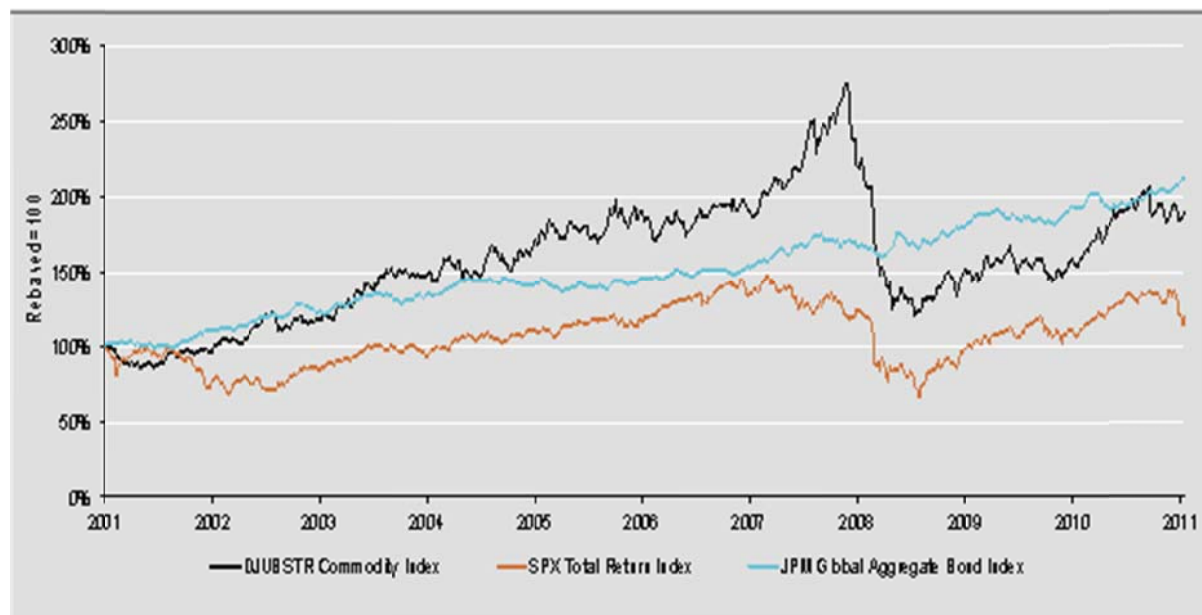
The appeal of commodities

Pension funds have increased their exposure to commodities significantly over the past 10 years for several reasons:

- Commodities have provided excellent long-term investment returns, significantly outperforming equities (see below).

10-year performance of bonds, equities and commodities

Solid Absolute Return performance



Source: Datastream, 7th December 2011

- Historically, commodities are uncorrelated with equities and negatively correlated with bonds and thus provide an important source of portfolio diversification.
- Commodities have long been recognised as offering a level of protection against inflation, especially unexpected inflation. Two main factors suggest that this remains the case despite recent volatility and the unexpected resurgence of what appears to be cost push inflation. Firstly, emerging markets growth is highly commodity-intensive, and will remain a key driver of commodity prices and hence inflation. The extraction and production of hydrocarbons, particularly crude oil, is also becoming increasingly difficult, leaving price as the only instrument to ration demand.

Secondly, commodities can provide an insurance against inflation during the current era of unorthodox government economic policies. Bonds would once have provided this protection, with yields rising as the authorities raised interest rates to tackle inflation. But there is little prospect of borrowing costs rising in the current

environment of anaemic economic growth and the yields of many sovereign bonds (treasuries, gilts and bunds, for example) currently offer significant negative returns when inflation is taken into account.

Debt pressures

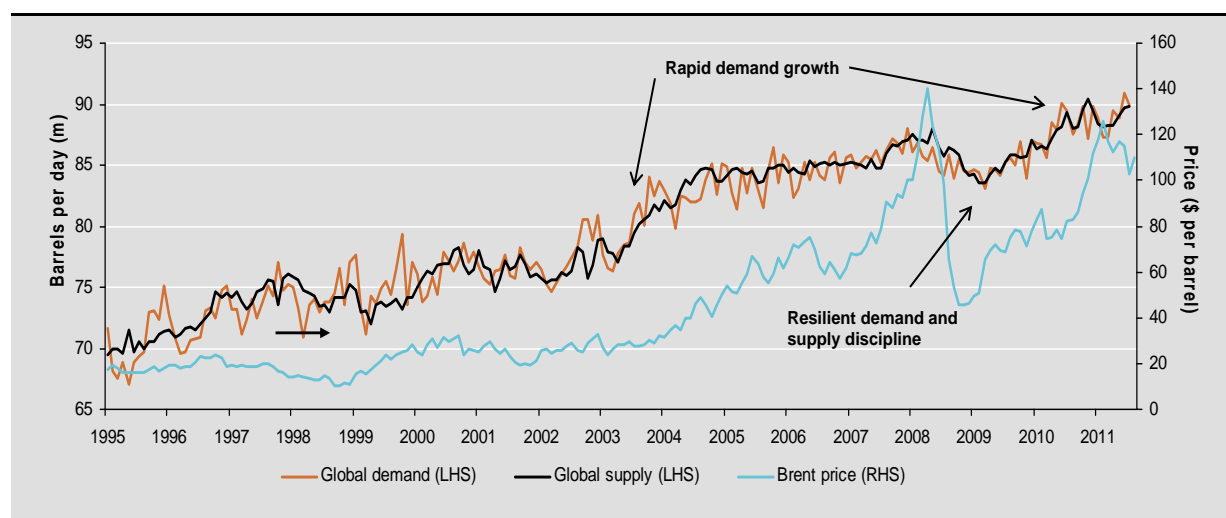
Additionally, given that much of the developed world is creaking under the weight of an unsustainable debt burden, the politically (in the short-term at least) less painful path is to allow the purchasing power of the currency to decline. This also mitigates against higher interest rates and is likely to lead to greater levels of volatility in commodity prices as financial flows wash in and out of markets. The risk of sharp increases in commodity prices, therefore, remains greater than normal.

The case for active investment in commodities

Commodity markets are individual and distinct with unique characteristics that constantly change and evolve over time. Trading or investing in commodities require specialist skills and experience that can adapt to these changes, a flexibility not open to those who adopt the passive strategies inherent in benchmark investing. Active investing allows for the exploitation of the many opportunities that regularly exist in all commodity markets.

For much of 2011, for example, we have been overweight oil and oil products, where the tightness of supply and the surprising resilience of demand, particularly over the last few months, has supported oil prices. Supply has been constrained by the continuing absence of about 1 million barrels a day of Libyan crude and the loss of much of Japan's nuclear electricity generation following the March tsunami and earthquake. The shortfall in supply has been exacerbated by strong demand from fast-growing emerging markets. Given that several OPEC countries need an oil price of approximately \$90 per barrel to balance their budgets, and the fact that Saudi Arabia has the only meaningful spare capacity on the planet, it became clear over the year that there was little downside to oil prices.

Global oil demand and supply close to balance



Source: Bloomberg, 28 October 2011

By contrast, for much of the year, we have been conviction underweight in US natural gas, a stance that highlights the impact and potential of applied technology to fundamentally change commodity markets. The US market, which faced an acute shortage of supply in 2008, has been transformed by the new technology that is opening up the country's shale gas reserves and the country now enjoys an abundance of cheap gas. For example, production at the Haynesville field, centred in Northwest Louisiana, which was non-existent three years ago now accounts for 10% of US total production. It is one of several significant production areas across North America. These shale resources are so prolific that North American gas storage capacity was in late 2011 approaching its limit, and there is little scope for exporting gas into the much higher priced world market until 2013 at the earliest.

Roll returns disadvantage passive investors

Roll yield or roll return is an additional factor that passive investors should bear in mind. It is generated as contracts roll forward in time due to the necessary convergence of spot prices and futures prices. An upward-sloping term structure (known as contango) results in a negative roll yield and has become a significant drawback for passive commodity index strategies in recent years. As a result, their investment returns have sometimes lagged spot commodity prices. By contrast, active commodity managers can seek to offset contango and mitigate negative roll yield by buying longer-dated contracts, where the curve may not be as steep and the cost of rolling forward could be reduced. Unlike passive and algorithm-optimised commodity products, we believe that forward-looking active management creates the opportunity to capture this performance on a regular basis. By positioning commodity allocation to take advantage of anticipated curve shape changes, active managers can benefit from structural changes in the market.

Emerging market growth to support commodities

We are cautiously optimistic looking forward with expectations that global growth could be close to 3% in 2012. Furthermore, growth could exceed this level if meaningful steps resolving the eurozone debt crisis are implemented. The private sector is in reasonable shape and has pent up investment and growth potential, which is currently obscured by the deluge of negative news around public sector issues in the developed economies.

For commodities markets, perhaps the most important macro development is that inflation has finally begun to abate in China. On the last day of November, China eased monetary policy for the first time in three years, reducing the required reserve ratio for all banks by 50 basis points, starting on 5 December. This move should mark the start of a monetary easing programme, which we consider essential to support global growth in 2012. As we witnessed in the summer of 2008 and towards the end of 2010, global growth, especially that driven by emerging markets, is resource intensive, particularly in terms of energy.

Active management set to growth with the market

Commodity investment is just beginning to move from passive to active, with less than 20% of total investment estimated to be currently under active management. This is largely a function of how this asset class has evolved and we believe that in five to 10 years commodities will be a trillion dollar asset class dominated by active managers. The developments of the individual markets, the increasing universe of investable commodities and the need to generate returns commensurate with spot performance all point to the trend to active management continuing.

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