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# Facts and Fantasies about Commodity Futures

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Pages 47-68 | Published online: 08 Apr 2019

Cite this article <https://doi.org/10.2469/faj.v62.n2.4083>

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Despite being an old asset class, commodity futures are not widely appreciated. Futures contracts are agreements to buy or sell a commodity at a future date at a price that is agreed upon today. Except for collateral requirements, futures contracts do not require a cash outlay for either buyers or sellers. The buyer of a futures contract is, on average, compensated by the seller of futures if the futures price is set below the expected spot price at the time of the expiration of the futures contract. The opposite is true when the futures price is set above the expected future spot price. In 1930, John Maynard Keynes postulated that sellers of futures (hedgers) would, on average, compensate the buyers of futures (speculators)—a situation he referred to as "normal backwardation." By examining the returns to futures over long periods, we indirectly tested this Keynesian prediction.

We constructed a dataset of returns on individual commodity futures going back as far as 1959. The dataset combines information about individual commodity futures prices obtained from the Commodity Research Bureau (covering, among other exchanges, the Chicago Board of Trade and Chicago Mercantile Exchange) and the London Metal Exchange. We computed investment returns by rolling positions in individual futures contracts forward over time. Commodity futures were combined into an equally weighted index, and much of the article is concerned with the behavior of this index.

We show that over a 45-year period, a diversified investment in collateralized commodity futures has outperformed a diversified investment in stock returns. The economic significance of this result is that the risk premium for commodity futures (relative to a diversified investment in stocks) is the key to the success of commodity futures. This result is very important because it shows that a diversified index of commodity futures can provide a return that is significantly higher than a diversified index of stocks.

The return on a diversified index of commodity futures has exceeded the return on a diversified index of stocks by about 10% per year since 1959. This result is significant because the 1959-2004 period is a period of high volatility in commodity prices, and the deviation of the return on commodity futures from the return on stocks is relatively large.



Commodity futures are less risky by other standards. First, the distribution of commodity futures returns is skewed to the right, whereas equity return distributions are skewed to the left. In other words, relative to a normal bell-shaped curve, equities experience proportionally more crashes whereas the "crashes" in commodities most often occur on the upside, leading to positive returns to investors in commodity futures. Second, commodity futures have the ability to diversify portfolios of stocks and bonds. The sources of the diversification benefits are the ability of commodity futures to provide a (partial) hedge against inflation—stocks and bonds are poor hedges by comparison—and to partially offset the cyclical variation in the returns of stocks and bonds.

Finally, when we compared an investment in our index with a portfolio of stocks of commodity-producing companies, we found that these portfolios are not close substitutes: The stocks of commodity producers are more correlated with the broad stock market than with an index of commodity futures.

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