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Facts and Fantasies about Commodity Futures

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returns on stocks and bonds, and (4) are positively correlated with inflation. The asset class is an investment in commodity futures.

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.

We show that the returns to the commodity futures index are positively correlated with stock returns. The economic significance of the commodity futures return (the reward for providing liquidity to the market) is the key to the success of the futures market. The key to the success of the futures market is the ability to diversify the index of commodity futures.

The average return to the commodity futures index has exceeded the return to the S&P 500 index about the same amount as the 1959–2004 period. The standard deviation of the commodity futures index is less than the standard deviation of the S&P 500 index stems

from the fact that the pairwise correlations between individual commodity futures are relatively low.

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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