HindeSight

HINDE CAPITAL

www.hindecapital.com
January 12

The Myth of Commodity Diversification



"Our age cannot be completely understood if all the others are not understood. The song of history can only be sung as a whole."

Jose Ortega Y Gasset

"The art of getting rich consists not in industry, much less in saving, but in a better order, in timeliness, in being at the right spot."

Ralph Waldo Emerson

"Do not wish for quick results, nor look for small advantages. If you seek quick results, you will not reach the ultimate goal. If you are led astray by small advantages, you will never accomplish great things."

Confucius

"I can stand brute force, but brute reason is quite unbearable. There is something unfair about its use. It is hitting below the intellect."

Oscar Wilde

We start with an extract from February 2011's HindeSight Investment Letter entitled Gold Portfolio Management:

> "There is no such thing as a bad investment class (ruling out cigar bars and fraud), just poor timing. Every asset class has had periods of great returns and periods of poor returns. To enjoy the success of good returns often boils down to two basic determinants:
>
> 1. Current valuation with regards to historic valuation, relative to simple metrics in the sector and relative to other asset classes.
> 2. Assessment of the stage in the business/credit cycle and the prevailing economic conditions."

Investors will face considerable difficulties in allocating funds successfully in the coming years. Zero interest rates and unconventional monetary easing across much of the world, coupled with anaemic growth and low future potential will be the status quo. They are a direct function from the fallout of over indebted sovereigns and private-sector balance sheets. Distorted interest rate horizons such as we experience today will serve only to muddy the waters of investment and economic policy for many years to come.

Investment strategies are like fashion, with assets falling in and out of favour like dress styles or the cut of a shirt. Whether it is Japanese stocks or CDOs, the pattern is generally the same: cheap → fair → rich → bubble → bust → forgotten. Commodities are no different. When some of us began our careers in investment banking almost thirty years ago, commodities were still very much in vogue, with firms like Cargill and Louis Dreyfus as well known as Merrill Lynch and Goldman Sachs are today. As the first sprouts of financial engineering emerged, many of the lessons learned were with a real rather than synthetic product in mind. The early financial futures "basis traders" had cut their teeth on the basis trading of *actual* products such as grains or metals. Stories were abound, some perhaps apocryphal, of junior traders camped out on Harwich docks with a pair of binoculars and pocketfuls of phone change. Desperately they scribbled the delivery schedules of the incoming ships, trying to assist their firm's ability to determine and profit from some esoteric investible like the December-March calendar spread.

Where once stocks and bonds had remained in the shadow of commodities, over the next twenty years they reigned supreme. The new 'masters of the universe' were fixed-income traders, immortalised in Tom Wolfe's iconic book the 'Bonfire of the Vanities'. The volatility of the instruments they traded created the opportunity for outstanding returns. At the turn of the millennium commodities returned to the fore, gold especially providing exceptional returns, although it is really only in recent years that the average investment manager has been allocating real money to the commodity arena. But is this a wise decision and is the timing too late?

Over the next few pages we will try to give some insights and thoughts about the investment history of the commodity arena, and its potential for the future. With the use of charts and tables[1] we will attempt to demonstrate some basic concepts with regard to:

- Commodity Cycles and Economic conditions

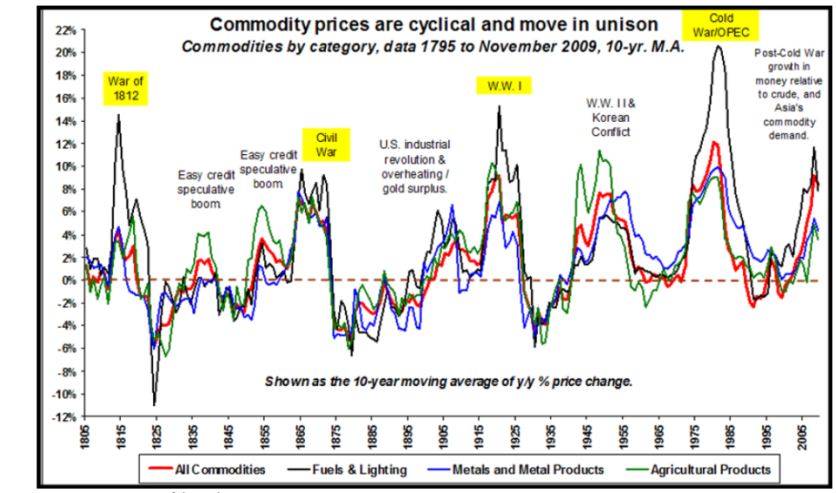
[1] At Hinde Capital, where possible, we use the investment period of 1971 to present day for our charts and analysis. While some would argue it is too short or too long a time frame, we believe the last four decades, ie since 1971 when Nixon 'closed the gold window' and the world moved to a wholly fiat monetary system, as the most appropriate time period to examine.

- Valuations
- Commodity indices
- Correlation risk of commodities
- Gold

The commodity arena is grouped broadly into four main areas: *energy, industrial, agriculture & softs, and precious metals*. The charts below take a representative commodity from each sector – oil, copper, wheat and gold respectively – and show how they have performed in both real and nominal terms over the past 40 years (nominal prices have been deflated by US headline CPI to get real prices).

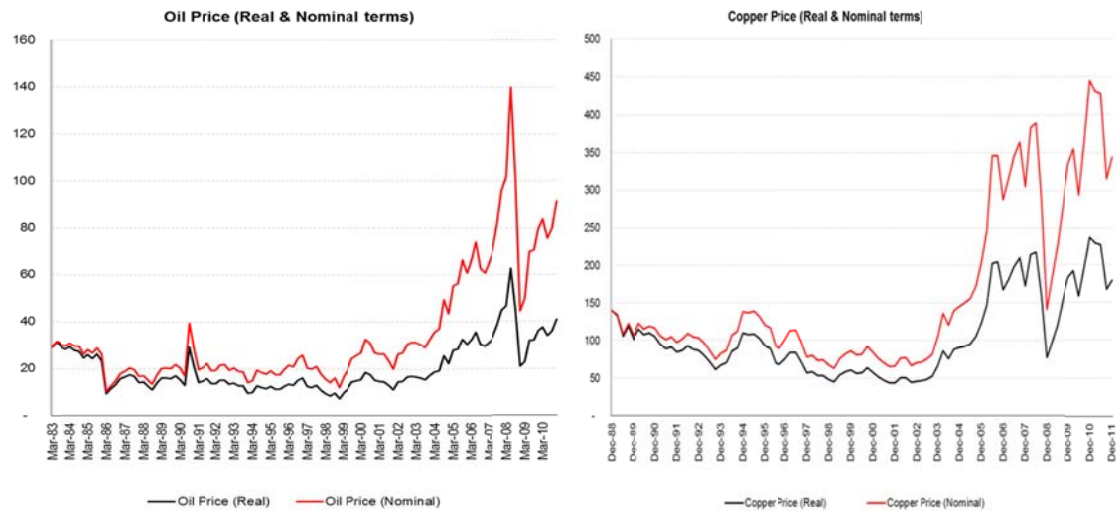
Commodity Cycles and Economic Conditions

Periodically, throughout history, commodities have had times when they have performed well, and other times where they have been in the doldrums. The chart below shows these cycles over the past 200 years.

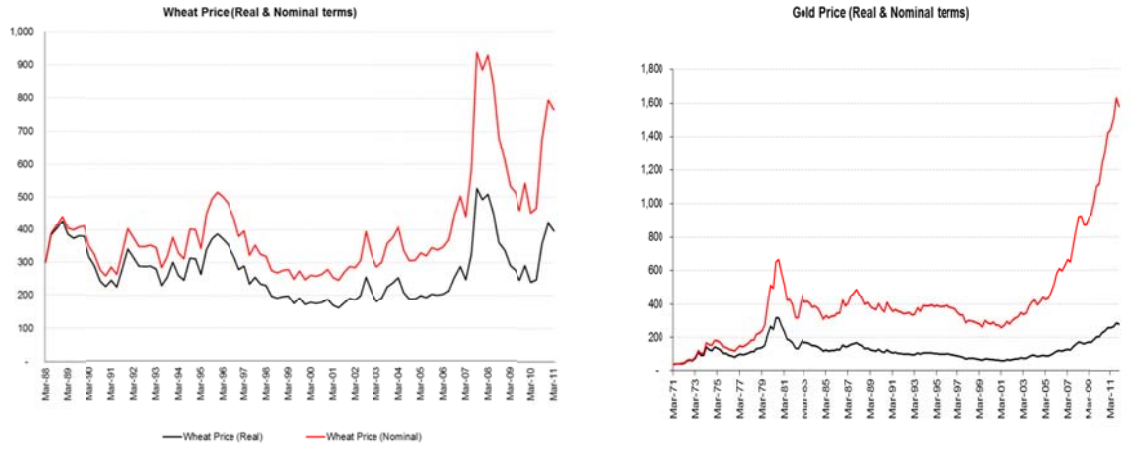


Source: Barry Bannister, Stifel Nicolaus

However, it was not until recent years that the real and nominal prices of commodities started to significantly diverge, as the charts below demonstrate. Once Nixon closed the Gold Window in 1971, central banks in a non-commodity based monetary system were able to manufacture inflation with virtual impunity.

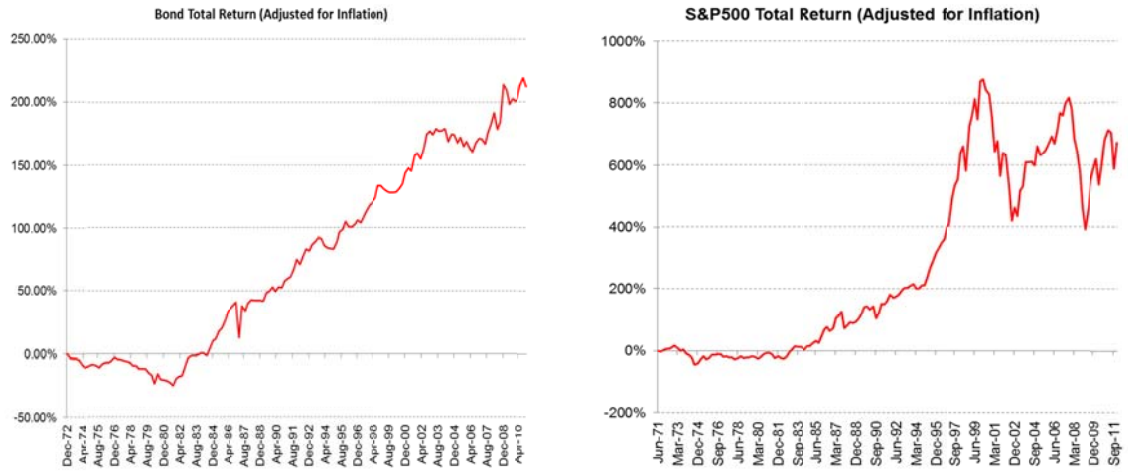


Source: Bloomberg



Source: Bloomberg

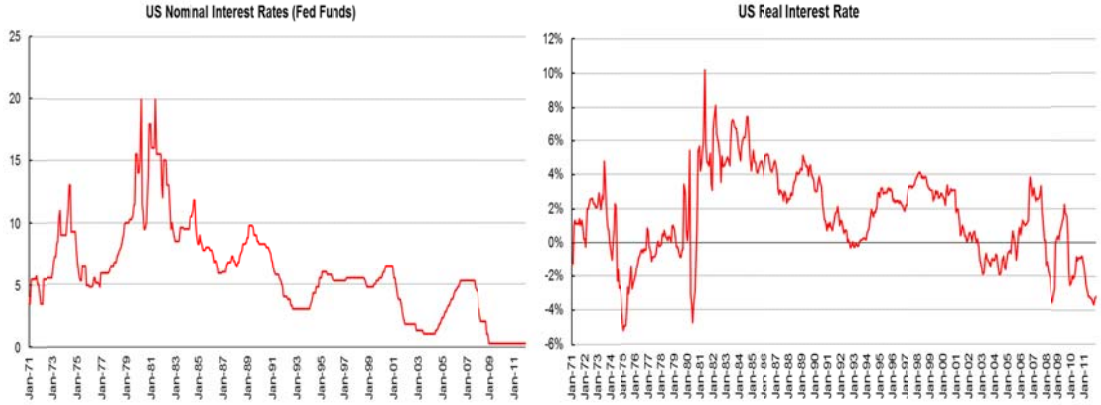
The charts above also show that commodities, by and large, were in the doldrums through the years 1980 – 2000. This was mainly because real interest rates made stocks and bonds more attractive. Stocks benefited from low inflation and solid growth, whilst bonds entered into a secular bull market from a starting point of attractive high yields and then falling inflation. Even in real terms, these two asset classes performed very well through the 80s and 90s.

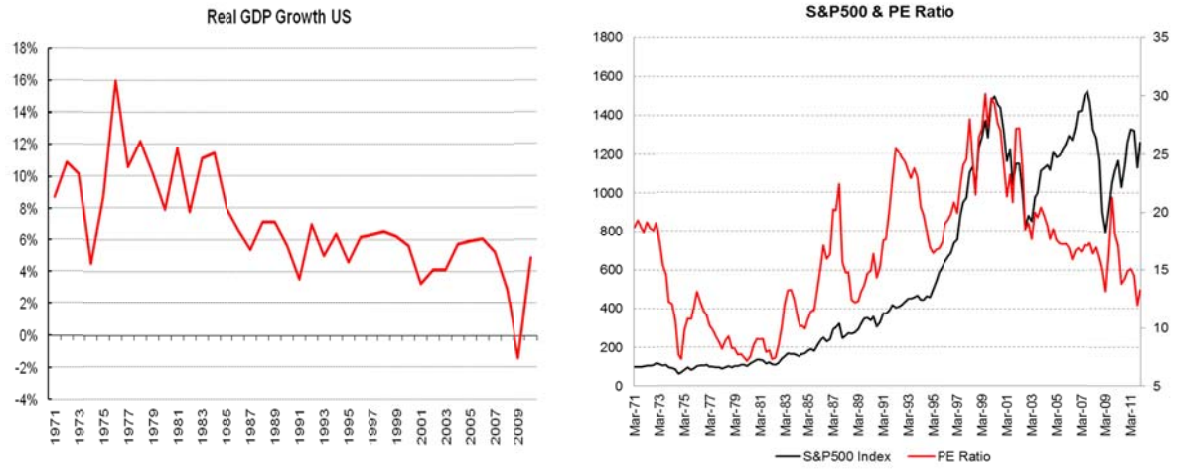


Source: Bloomberg

Clearly the savvy investment manager would have avoided the 'wilderness' years of 1980 to 2000 in commodities, taken part in the 'wonder' years in stocks and bonds enjoyed over the same period, and then shifted into commodities to benefit from their latter boom over the last decade.

But is it as simple as this? That is, did falling nominal interest rates - while real rates were positive but declining - combined with a fundamentally cheap equity market at the beginning of the 80s, *really* lead to the wonder years for the equity and bond markets? It may have seemed this way at the time but, as the Machiavellian Francis Urquhart puts it in House of Cards, "Nothing lasts forever. Even the longest, the most glittering reign must come to an end someday."





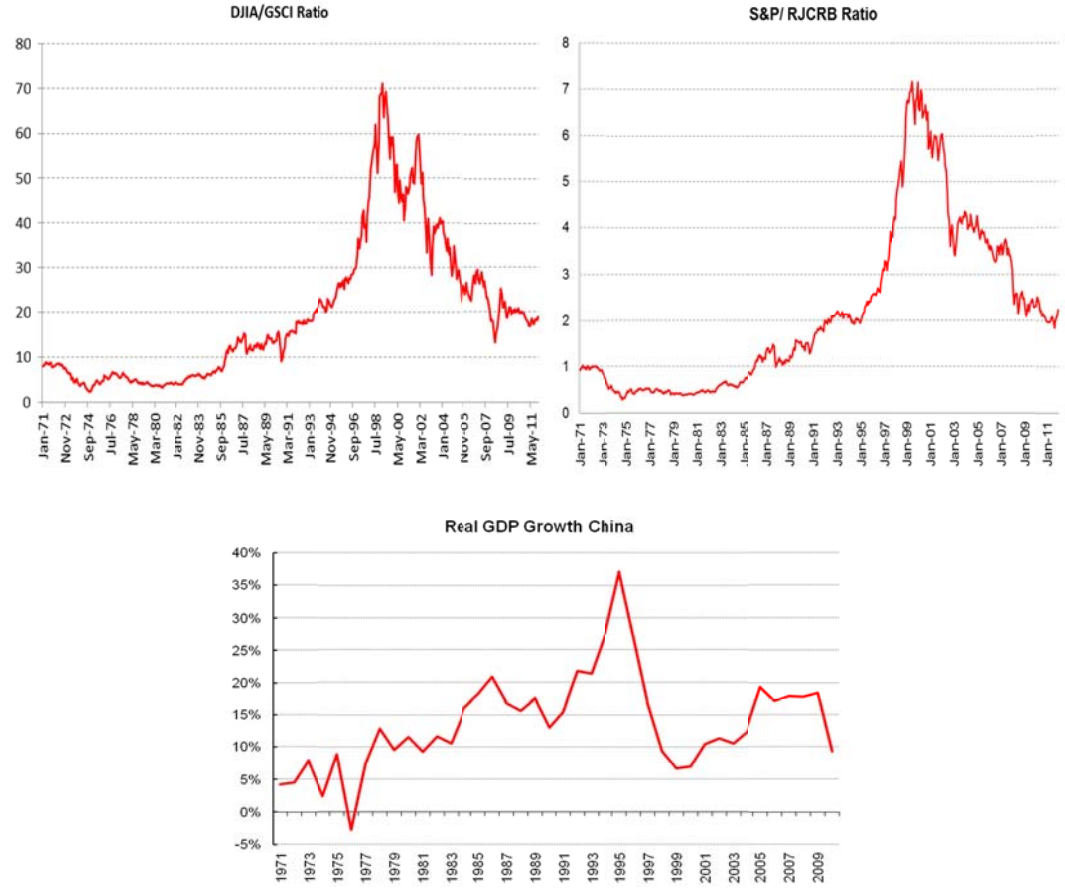
Source: Bloomberg

Valuations

The 1980 to 2000 years that many investment managers still regard as the 'norm' were clearly not. With high nominal interest rates and low price/earnings the stage was set for excellent returns, but it was very high real rates that were the driving factor. As investors received a huge inflation premium, bond yields dropped steadily, aiding the global economic growth profile dramatically and providing near optimal conditions for equity markets.

Despite high growth producing rapidly rising stock prices in the latter two decades of the twentieth century, commodity prices remained stagnant. Given that the output of all equities, whether it is construction or retail stocks, rely on the input of raw commodities as the main factor behind profit margins and business sustainability, one might be led to believe that high growth and therefore high demand would drive commodity prices. But in the 1980s and 1990s this did not happen. It would appear that real interest rates were – and still are – the primary driver of commodity prices.

Commodity prices stagnated while equity prices roared throughout 1980 to 2000. Unsurprisingly, commodities became extremely cheap on a relative basis. The ultra-cheap valuations of commodity indices relative to stock markets around the turn of the century coupled with the lowering of real interest rates created a great opportunity to switch out of equities and into commodities. This was magnified by China arriving on the scene. They bought up commodities with a ferocity unseen in the industrial world; their dual aim to supply their infrastructure and labour programs. Commodities entered a spectacular bull market as the twenty first century dawned.



Source: Bloomberg

Commodity Indices

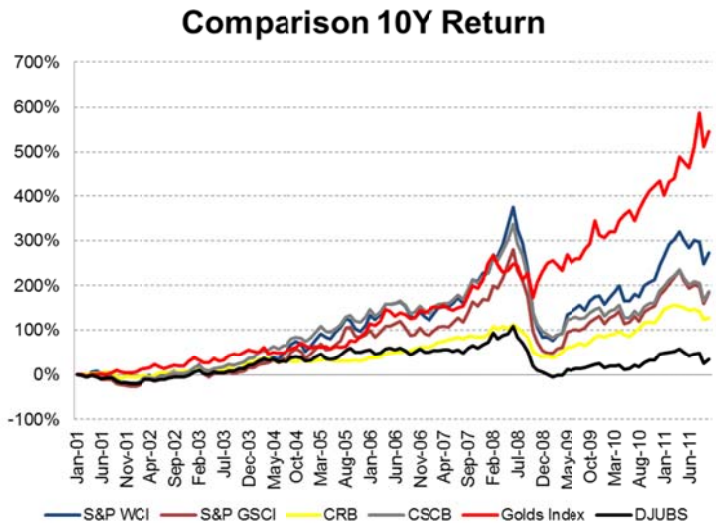
When investment managers, whose specialty is not commodities, invest in them, they tend to do so through a commodity index, ie a basket of commodities. So let's now look at some of the main commodity indices. We believe quite reasonably that the main reasons 'non-traditional' commodity investors started to buy into the bull market over the last decade or so was to diversify, and especially to do so with respect to their equity portfolios that had so spectacularly blown up in the late 1990s (Asia EM), and the early 2000s (US and Europe after the bursting of the US 'Tech' bubble).

We want to illustrate that using commodity indices is not necessarily a great hedge for emerging and global equities in the long run. We have used 5 commodity indices as the basis for our analysis:

- Standard & Poor Goldman Sachs Commodity Index (S&P GSCI)[2]
- Standard & Poor World Commodity Index (S&P WCI)
- Dow Jones UBS – Commodity Index (DJUBSCI)
- Thomson Reuters/Jefferies Commodities Research Bureau Index (TR/Jefferies CRB Index)
- Credit Suisse Commodity Benchmark Index (CSCB)

(Please see Appendix I at the back of this report for a full description of these indices.)

The chart and table below show the consecutive 10 year returns for gold and the commodity indices listed above:



Source: Bloomberg

	Gold Return	**Average Commodity Index Return**
1971-1981	1237.47%	128.87%
1981-1991	-27.74%	-22.90%
1991-2001	-27.36%	16.73%
2001-2011	401.34%	188.70%

These show clearly the torrid time all commodities, including gold, had in the 'wilderness' years of 1980 to 2000, as well the bull markets they enjoyed in the Seventies and the last decade. Clearly, gold has performed better than the indices in these last two commodity bull markets.

Next we look at the composition of the indices. The indices include up to 26 individual commodities which can be grouped into the 4 broad categories. The table below shows the average composition of each index over the last 10 years.

	GSCI	WCI	DJUBS	CSCB (5 Yr)
Energy	68.33%	71.87%	32.94%	53.81%
Industrial	7.51%	10.79%	18.06%	13.78%
Precious Metals	2.61%	3.15%	10.12%	6.17%
Agriculture	21.55%	14.19%	38.88%	26.25%

Most of the main indices are heavily weighted to energy, even more so to energy plus industrial commodities. Therefore for equity managers seeking diversification, they are in reality receiving only a narrow band of diversification, which may well augment risks in a portfolio, rather than mitigate them.

Correlation risks

Moreover, when one examines the correlation between the commodity indices and equity markets, this further highlights a mistaken belief that buying commodities constitutes prudent diversification.

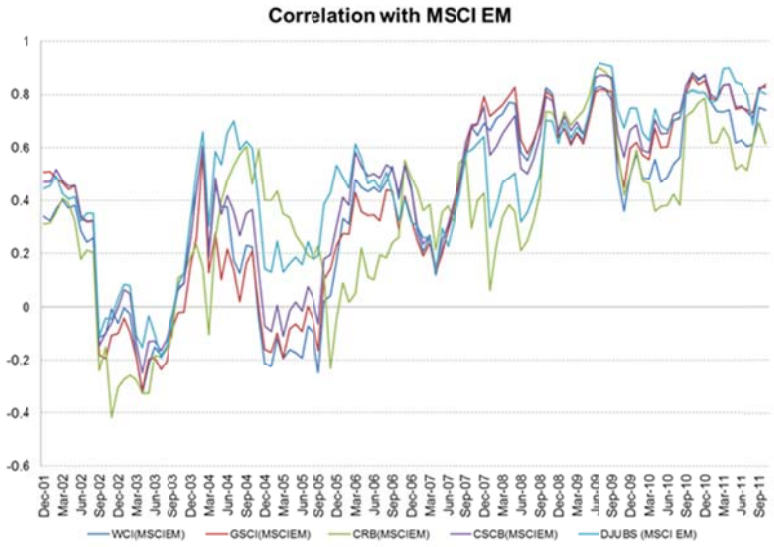
The table below shows the 1 year rolling correlation between the MSCI World & MSCI Emerging Markets equity indices and the commodity indices, averaged over the last 10 years.

	MSCI World	MSCI EM
WCI	43.10%	50.36%
GSCI	42.67%	50.42%
DJUBS	51.23%	57.43%
CRB	50.48%	51.97%
CSCB	51.48%	57.87%

The correlations are even higher if one looks over the past 5 years.

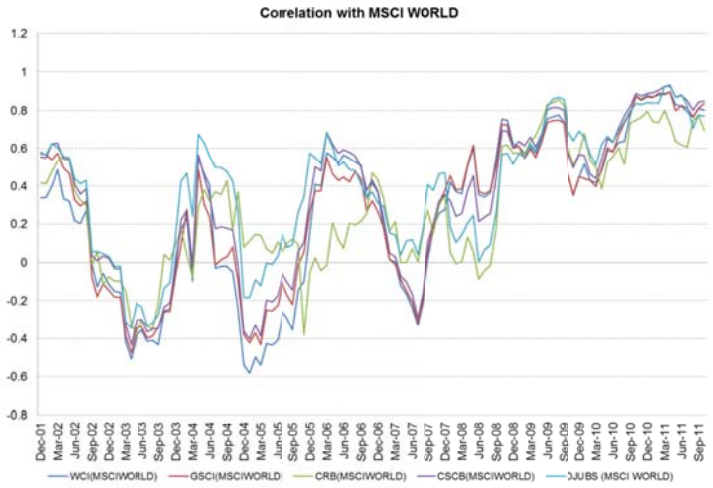
	MSCI World	MSCI EM
WCI	51.25%	61.63%
GSCI	25.23%	65.51%
DJUBS	53.87%	63.08%
CRB	51.40%	65.45%
CSCB	53.19%	66.18%

The chart below illustrates the historical values of the correlations given above to the MSCI EM. It can be seen that all the correlations have been trending up over the last 5 years.



Source: Hinde Capital, Bloomberg

The same can be seen when observing the correlations to the MSCI World.



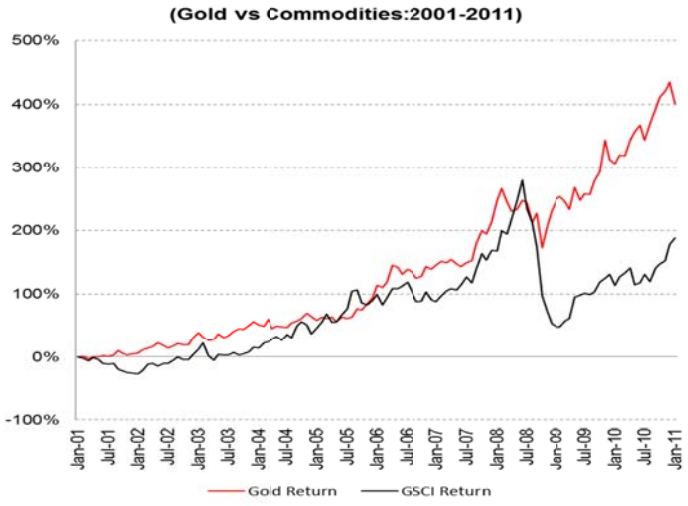
Source: Hinde Capital, Bloomberg

These series of tables and charts alone should start raising a few eyebrows at the desks of equity investment managers who are looking to 'diversify' into commodities. There is, though, another sound and proven alternative.

Gold – A True Portfolio Diversifier

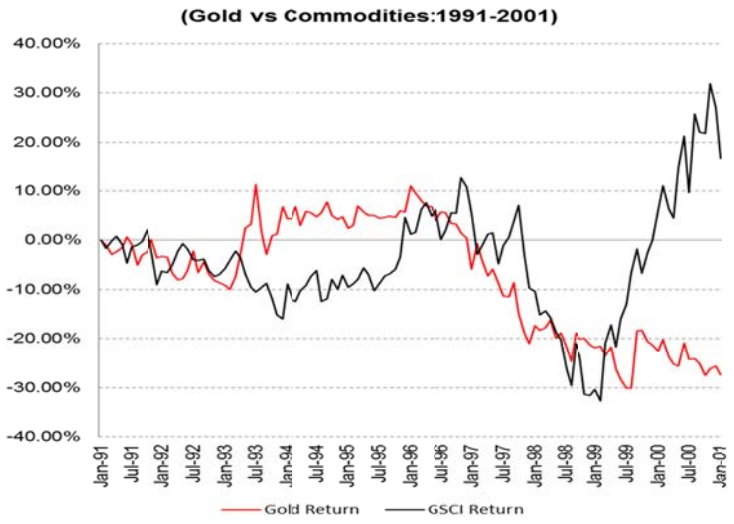
Despite the low weighting of precious metals in many of the standard commodity indices, gold has some characteristics that should be of interest to investment managers. While gold is not principally a commodity – it is not consumed, and should be thought of as money – it does display some commodity-like tendencies. Foremost is its relationship with real interest rates.

Gold, along with commodities in general, benefitted from the low and negative real interest rates of the last decade.



Source: Bloomberg

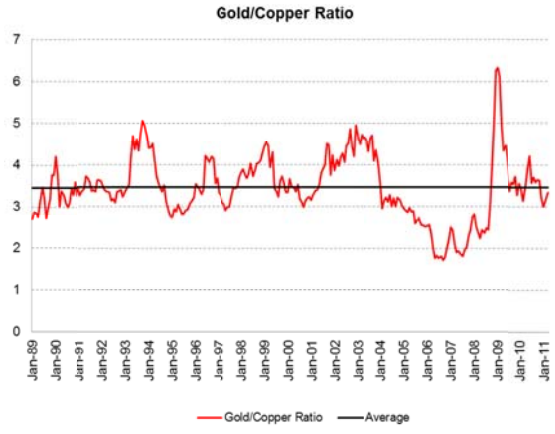
Gold suffered alongside commodities, when real interest rates were rising and positive, as was the case throughout the 1990s.

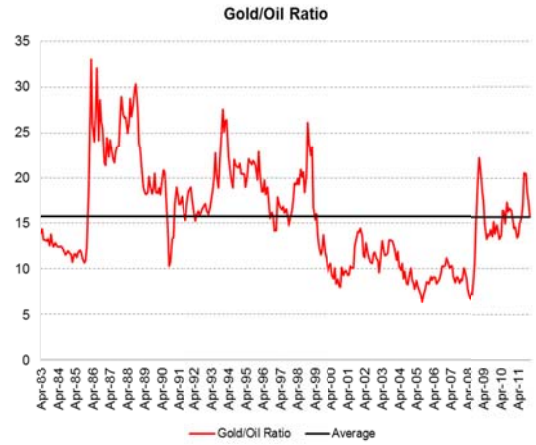


Source: Bloomberg

However, the similarities end here. Gold exhibits a unique quality which commodities do not. It retains its purchasing power - over the long term - relative to other 'things'. Oil, copper, wheat, etc may have rallied aggressively over the last decade, but these are priced in the same currencies central bankers and government policymakers are debasing as fast as they can to 'avoid' a perceived oncoming and stubborn deflationary environment. If the real prices of these commodities falls in relation to the real prices of other goods and services, then you are not preserving your wealth.

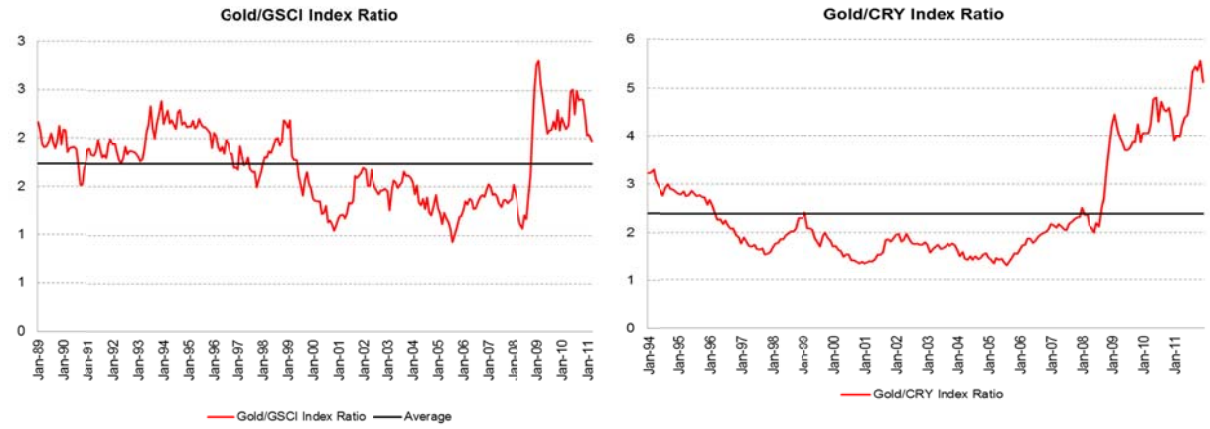
Gold, on the other hand, does tend to hold its long-term value, as the following charts show. The gold ratio in conjunction with, for example, copper and oil tends to revert to its mean. Thus, for instance, an ounce of gold bought you roughly the same amount of copper as it did twenty years ago.





Source: Bloomberg

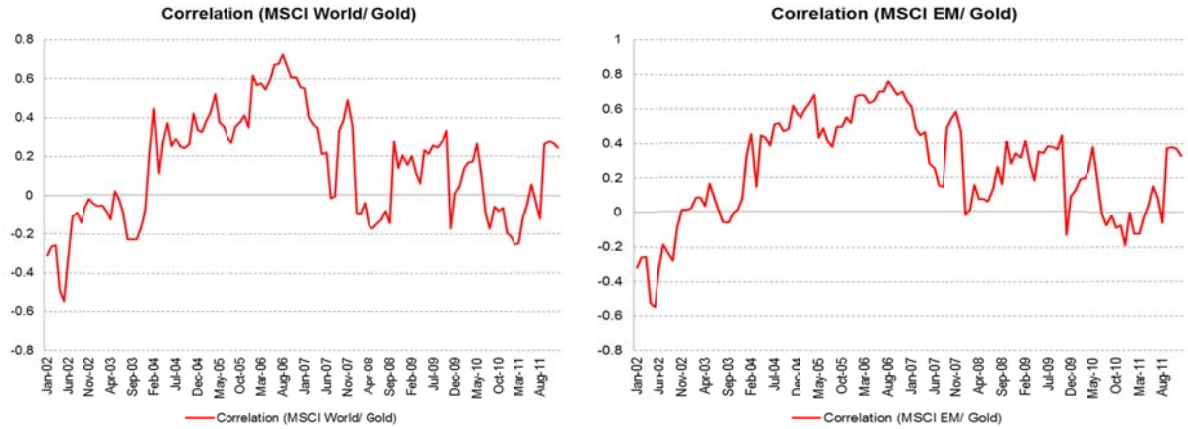
Oil and copper are close to their means in terms of their ratio to gold. This is why the gold to GSCI ratio is close to its mean, as the index is heavily weighted to both oil and copper. The CRY Index in relation to gold, however, makes gold look expensive. The CRY Index is a broader index that contains a much wider range of commodities, some of which are less close to their long-term average in gold terms than oil and copper. In an environment where growth continues to disappoint and demand wanes, the CRY-to-gold ratio could remain extended and above its mean for the foreseeable future.



It is apparent that gold also displays a much lower correlation to global and EM equities than do any of the main commodity indices presented. The table below shows the one year rolling correlations of gold vs MSCI World and MSCI EM, averaged over the last five years.

	MSCI World	**MSCI EM**
Gold	7.00%	19.34%
WCI	51.25%	61.63%
GSCI	25.23%	65.51%
DJUBS	53.87%	63.08%
CRB	51.40%	65.45%
CSCB	53.19%	66.18%

Moreover, as the following charts show, gold has a negative correlation to equities when they sell off, ie gold tends to go up when equities fall. It is a true diversifier.

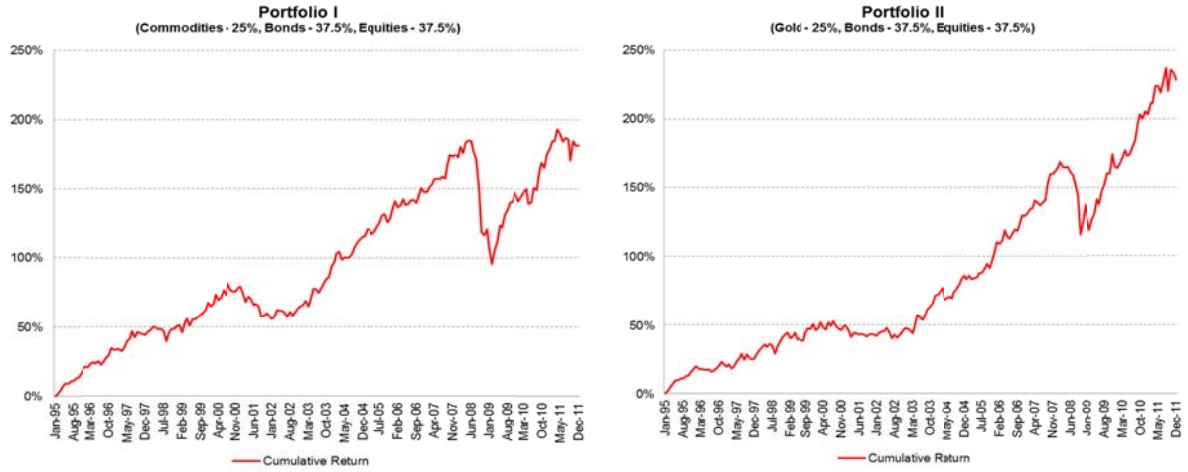


Source: Bloomberg

The S&P GS Commodity Index has a weighting of only 2.61% on average to precious metals over the last 10 years. Clearly this index would provide an insufficient portfolio protection for an equity portfolio should equity markets encounter a severe correction.

Sadly most managers still believe gold doesn't provide enough diversification to hold within a portfolio, let alone consider it as a standalone investment. We would ask, though, have they considered a simple choice between two basic portfolios which illustrate our point that gold is a superior diversifier and protector of portfolios?

The first portfolio is 25% commodities, 37.5% stocks & 37.5% bonds; the second is the same except the commodities portion is substituted for gold.



Source: Bloomberg

Over the last 15 years, the second portfolio, with gold substituted for a commodity index, would have performed better than the first one. Indeed, over almost every 5 year period we have highlighted, the second portfolio outperforms the first one. Furthermore, as we have shown above, the first portfolio is a less effective diversifier. In actual fact, far from providing protection through diversification, it amplifies risks. The correlation risks associated to the equity markets results in greater drawdowns should equities sell-off. One can reasonably conclude that for optimal performance and diversification, gold is superior to a basket of commodities.

The World Today

So where does this leave us now? The world today continues to exhibit a fragility that policymakers have only magnified. If we believe the world of today is a dangerous place, both economically and socially then the world tomorrow is likely to be worse. Investment managers will struggle with the choices available to them.

In 'Brewster's Millions', a comedy film from the 1980s, Richard Pryor attempts to throw away his millions by running for Mayor of New York. His campaign address to the electorate was to vote for 'None of the Above'. It superbly parodied the poor political choices available at the time. We would consider a similar lack of choice is applicable to investments available today.

- Cash is no longer safe in 'segregated' accounts even allowing for the ravages of inflation. We all by now have some comprehension with the issues associated with MF Global.

- Bonds, sovereign or corporate offer only negative real returns at best and they offer imminent default at worst. The financial repression which forces sovereign bond purchases by financial entities, so enabling indebted nations to continue to finance themselves will only continue and a greater rate than prevails today.

- Developed world equities are not cheap based on the usual metrics, and with growth prospects poor throughout much of the developed world, then any positive returns made are likely to be nominal – as inflation will entail real returns are most likely negative.

- Commodities can benefit from high negative real rates, but low growth and very high correlation to worldwide equities make these a poor portfolio option.

So what can we conclude? As investment managers of Hinde Gold Fund we are no doubt biased in our opinion. Gold discussion seems to bring out the worst in people. Hate it or love it; there are no fence sitters here. Yet gold, we should remember, is just another asset, one that should have its *time* and *place* in portfolios. **Negative real interest rates, as all savvy investors should understand, implies that this *time* is now; and as a true diversifier – unlike broad commodity indices that in fact amplify overall risk – gold demands also its *place* in investors' portfolios.**

Recently, Lionel Messi, the renowned Argentine footballer received the Ballon d'Or, for the third year running, the ultimate soccer accolade for a man only twenty four years of age. He has already equaled Michel Platini's record. Messi, who plays for FC Barcelona, arguably the world's most successful club today, has won five La Liga titles and three Champions League titles, scoring an incredible 53 goals in all competitions in the 2010-2011 season.

Come every Saturday morning, you will find Josep Guardiola, the FC Barcelona manager, mulling over his team selection. Following a diet of Spanish churros and pungently strong coffee, Guardiola will get out his blank team sheet. Pausing for at most a moment, he will write one word: Messi. First name on the team sheet. Always.

In this time of negative real rates, low growth and financial repression where high inflation is seen as the preferred option, you could do worse than make gold the first name on your investment 'teamsheet' and build your portfolio from there.



Source: AP

Appendix I

Weightings – This is proportion assigned of each commodity within the index. This is agreed upon by a committee annually.

Rebalancing – The process of realigning the weightings of one's portfolio of assets. Rebalancing involves periodically buying or selling assets in your portfolio to maintain your original desired level of asset allocation.

Rebalancing happens monthly as each commodity exhibits relative performance which may increase its weighting. For example if WTI Oil was 10% of the portfolio and it went up 20%, then it would compromise actually now 12% within the portfolio.

S&P GSCI

The S&P GSCI is composed of 24 commodities which include energy products, industrial metals, agricultural products, livestock products and precious metals. It was originally developed by Goldman Sachs however in 2007 Standard and Poor's assumed ownership and since then has been publishing it. The index has a relatively high exposure to the energy sector however a wide range of commodity participants provide the S&P GSCI with a high level of diversification. This enables the index to negate the impact of any skewed events. The index is production weighted and therefore it is based on the average production quantity of each commodity within the index over the past five years. This methodology enables the index to be a measure of investment performance. The production weightings are allocated to each commodity and this is decided by the amount of capital dedicated to holding each asset. The method used is very similar to using market capitalisation which is used to assign weightings within an equity index.

S&P World Commodity Index (WCI)

The S&P World Commodity Index is a tradable commodity index which consists of futures contracts traded on international exchanges outside of the United States which are readily accessible to global investors. The index is rule-based and world-production weighted. It consists of 22 commodities covering the agriculture, energy and metals sectors. These commodities are listed on eight international exchanges and traded in six currencies through Asia, Europe and N.America.

The production weighting used within the index are used to keep the weights of the individual commodities within each basket proportional to their world production. These are averages of their historical production levels which are updated every year. The S&P WCI was created to meet market demand for a benchmark that would complement the US focused S&P GCSI as this would provide global commodity exposure. The WCI includes commodities traded on exchanges across Europe, North America and Asia.

The index is calculated in USD; however the underlying futures contracts are collected in local currencies. Using WM/Reuters spot exchange rates, these local prices are converted to U.S dollars. World production weights are averages of historical production levels and are generally updated every year.

The annual weighting of each commodity is decided by a committee. This committee oversees the daily management and operations of the S&P WCI. At each meeting the committee reviews any issues that may affect index constituents, statistics comparing the composition of the indices to the market, commodities that are being considered as candidates for addition to an index and any significant market events.

Dow Jones – UBS Commodity Index

The Dow Jones UBS commodity Index is currently made up of exchange-traded futures on physical commodities. It represents 19 commodities which are weighted to account for economic significance and market liquidity. The index has four main themes which it has been built upon which include: economic significance, diversification, continuity and liquidity. To prevent any single commodity/commodity sector from dominating the index, the DJ-UBSCI has been developed and modified based on several diversification rules. The Index is composed on no related groups of commodities such as energy, precious metals, livestock or grain that constitute more than 33% of the index. Paired with this no single commodity can constitute less than 2% of the index.

The Index's historical returns started in 1991; however its first publication was 1998. Rebalancing is important as this helps to avoid over-concentration in any one particular commodity. The Index is rebalanced and reweighted annually on a price-percentage basis.

Thomson Reuters/Jefferies CRB Index

The TR/Jefferies CRB Index was founded in 1957 and was last updated in 2005. The index is currently composed of 19 commodities which are listed on the NYMEX, CBOT, LME, CME and Comex. Originally the index was composed of 28 commodities. Of these 26 were traded on an exchange within the US and Canada. The purpose of the index was to develop a benchmark which would represent the broad trends within the commodities sector. Since 1957 the index has been revised ten times which includes the index components and weightings. The first revision was in 1961 and with the most recent was in 2005. The individual components have been continuously adjusted which have been used to form the index since the original 28 were chosen in 1957. These continuous revisions have been part of a continuing effort to ensure that it provides an accurate representation of the broad trends within the commodity market. Over the years commodities including eggs, oats, lard, rubber, potatoes and wool have been dropped and replaced by more liquid and significant contracts. The 10th revision which was conducted in 2005 included a weighting change from an equally weighted index to a four tiered group system designed to reflect the significance of each commodity tier.

The index is rebalanced on a monthly basis to its fixed target weightings. This helps to maintain the stability and basic composition of the index over time. Overall the rebalancing helps to lower index volatility. The index systematically decreases exposure to commodities that have trended higher in value and increases exposure to those commodities that may be relatively inexpensive.

In 1995 it was then decided that the revision lowered the number of forward deliveries included to those with six months of the current date, up to a maximum of five delivery months per commodity. Currently since 1995 a minimum of two delivery months must be used to calculate the current price even if the second contract is outside of the six month window.

Credit Suisse Commodity Benchmark Index

This Index includes a wide range of commodities weighted by world production and liquidity. It is rebalanced on a monthly basis but reweighted annually. It invests in futures that fall within first three months. The Index's historical returns started in 1998 however its first publication was in 2009. The Index invests in global futures.

Each commodity chosen for inclusion to the Index is then assigned a fixed annual weight based on relative commodity weight and target investment weighting. The relative commodity weight is a measure of production, or a percentage of worldwide production value divided by the total production value of all the commodities selected for inclusion.

Credit Suisse has a strategic relationship in commodities with Glencore who are one of the world's largest physical traders of the materials. They have leading market share in all key physical commodity markets and have a unique insight into the physical commodity markets. This strategic relationship covers energy, metals and agricultural products creating a fully integrated commodities platform spanning a wide range of underlying instruments. This relationship marries Glencore's leading position in physical commodities with Credit Suisse's extensive experience in derivatives.

DISCLAIMER

Hinde Gold Fund Ltd is an open-ended multi-class investment company incorporated in the British Virgin Islands.

This document is issued by Hinde Capital Limited, 10 New Street, London EC2M 4TP, which is authorised and regulated by the Financial Services Authority. This document is for information purposes only. In no circumstances should it be used or considered as an offer to sell or a solicitation of any offers to buy the securities mentioned in it. The information in this document has been obtained from sources believed to be reliable, but we do not represent that it is accurate or complete. The information concerning the performance track record is given purely as a matter of information and without legal liability on the part of Hinde Capital. Any decision by an investor to offer to buy any of the securities herein should be made only on the basis of the information contained in the relevant Offering Memorandum. Opinions expressed herein may not necessarily be shared by all employees and are subject to change without notice. The securities mentioned in this document may not be eligible for sale in some states or countries and will not necessarily be suitable for all types of investor. Questions concerning suitability should be referred to a financial adviser. The financial products mentioned in this document can fluctuate in value and may be subject to sudden and large falls that could equal the amount invested. Changes in the rate of exchange may also cause the value of your investment to go up and down. Past performance may not necessarily be repeated and is not a guarantee or projection of future results. The Fund is categorised in the United Kingdom as an unregulated collective investment scheme for the purposes of the Financial Services and Markets Act 2000 and their Shares cannot be marketed in the UK to general public other than in accordance with the provisions of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, the Financial Services and Markets Act 2000 (Promotion of Collective Investment Schemes) (Exemption) Order 2001, as amended, or in compliance with the rules of the Financial Services Authority made pursuant to the FSMA. Participants in this investment are not covered by the rules and regulations made for the protection of investors in the UK. Participants will not have the benefit of the rights designed to protect investors under the Financial Services and Markets Act 2000. In particular, participants will lose the right to claim through the Financial Services Compensation Scheme. The securities referenced in this document have not been registered under the Securities Act of 1933 (the “1933 Act”) or any other securities laws of any other U.S. jurisdiction. Such securities may not be sold or transferred to U.S. persons unless such sale or transfer is registered under the 1933 Act or is exempt from such registration. This information does not constitute tax advice. Investors should consult their own tax advisor or attorney with regard to their tax situation.