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Mutual Fund Investors Benefit from Diversification into Commodities

Washington, DC, May 9, 2012 - Fundamental economic factors—market demand and supply conditions—provide the most consistent explanation for recent trends in commodity prices, a new study released today by the Investment Company Institute finds.

The study, Commodity Markets and Commodity Mutual Funds, examined whether increased investment in commodity mutual funds, fueled by investors' desire to diversify their portfolios, has driven recent trends in commodity prices. The paper is intended to contribute to the important debate over recent developments in commodity prices and policymakers' concerns about the causes of these price changes.

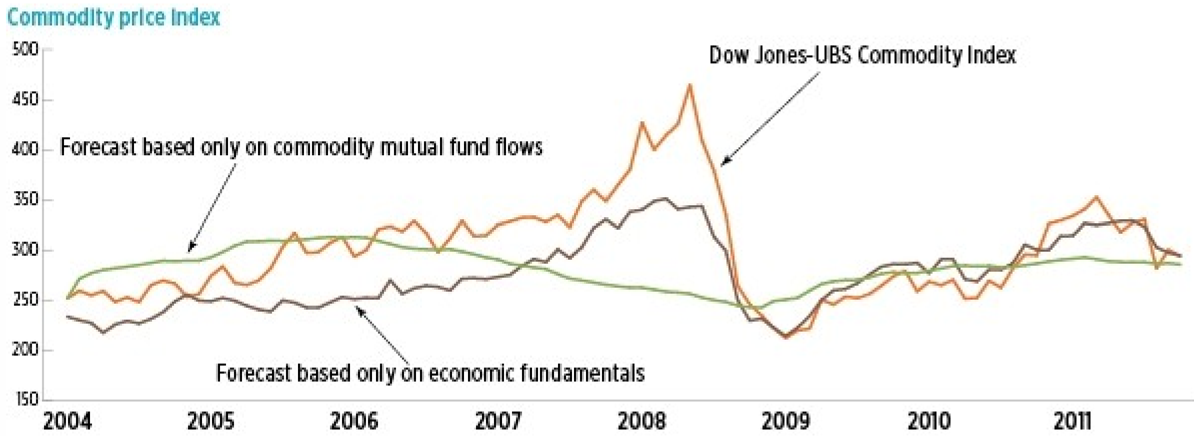
Fundamentals, not flows, explain commodity price changes

The study finds that the rise and fall of commodity prices on a monthly basis since 2004 has been strongly linked to the value of the U.S. dollar and the world business cycle—in particular, to the strength or weakness in emerging market economies such as China, Brazil, India, and Russia.

The chart below plots commodity prices (orange line) against the estimated influence of flows into commodity mutual funds (green line) and economic fundamentals (brown line).

Forecasts: Economic Fundamentals Versus Commodity Mutual Fund Flows

*Monthly, 2004–2011**



**Data and dynamic forecasts are from February 2004 to November 2011.*
Note: The correlation between the Dow Jones-UBS Commodity Index and the forecast based on economic fundamentals is 0.80. The correlation is -0.05 for the forecast based on flows.
Source: Bloomberg

"Our analysis in the figure clearly shows that economic fundamentals can explain the broad pattern in commodity prices," said ICI Senior Economist and study author, Chris Plantier. "By contrast, modeling based on flows into commodity mutual funds does not match the commodity price pattern and, in fact, incorrectly predicted that commodity prices would fall in 2007 and 2008."

Three reasons mutual funds flows didn't drive recent commodity price changes

The paper finds three key factors illustrate why flows into commodity mutual funds cannot explain commodity price movements:

- Commodity prices rose sharply from January 2006 to June 2008, but over the same period commodity mutual funds experienced net outflows.
- Flows into commodity mutual funds are spread across a wide range of markets and thus do not concentrate investment in a particular commodity.
- The $47.7 billion in commodity mutual funds as of December 2011 is miniscule relative to the size of global commodity markets, where commodity futures and options markets trade trillions of dollars in notional value each month.

Diversification important for investors

Commodity mutual funds are a relatively new development. They allow investors, especially retail investors, to obtain the diversification benefits of commodity investments, benefits that were historically much harder to achieve.

"Our job is to bring the best investment management tools to investors, and commodities are necessary to achieve the greatest investment impact," said ICI President and CEO Paul Schott Stevens. "It makes sense for investors to have portfolios diversified beyond stocks and bonds, and commodity exposure gives the investor such opportunities."

For more information, visit ICI's commodity investments resource page.