INITIATIVE FOR RESPONSIBLE INVESTMENT AT HARVARD UNIVERSITY

THE HAUSER CENTER FOR NONPROFIT ORGANIZATIONS at HARVARD UNIVERSITY

Commodities as an Asset Class: Appropriate for Responsible Investors?

On September 23, 2011, the Initiative for Responsible Investment, a project of the Hauser Center for Nonprofit Organizations, hosted a convening at the Harvard Kennedy School of Government to examine the social purposes of commodities markets, how these markets have evolved as an asset class, and the ways in which investors can understand the social impact of their commodities investments.

Some 25 participants drawn from the money management, academic, nongovernmental, financial consulting and think tank worlds attended. This short paper reports on the discussion at the meeting, which included a survey of human rights and environmental aspects of commodities investment, the role and consequences of speculation in commodities, and the potential for commodities investment strategies that create positive social benefits. It concludes with next steps for research and practice.

Commodities as an Asset Class: A Brief Overview

From their earliest days, the commodities markets have had a strong speculative aspect due to the usefulness of futures contracts. Recent years have seen commodities play an increasingly significant role in the asset allocations of institutional investors. These investments in commodities take a variety of forms, including those in real assets, futures, indexes, equities and hedge funds (although investors may not be aware of the commodities roles involved in these hedge funds). In portfolio management commodities can serve a variety of functions from volatility and/or inflation hedges to purely speculative plays.

Investing in commodities indexes has become particularly controversial due to their implications for commodities prices. These indexes have at times proved disappointing when anticipated diversification protection and returns have failed to materialize. Among the real-assets commodities, timber has one of the longest track records as a sustainable commodity play, with European institutional investors particularly active in this area in the U.S. More controversial are such real assets as rare earths and minor metals, where institutional investors are less likely to play, though there has been increased interest as new technologies create markets for these products. Investing in the public equities of commodities-related companies is an attractive play for investors, since they have outperformed other strategies by a substantial margin in recent years.

Commodities are thus a broad and diverse asset class with multiple options through which investors can enter these markets with a variety of differing financial, social and environmental implications.

Environmental and Human Rights Aspects of Commodities Investment

For commodities, perhaps more than for other asset classes, human rights and environmental issues are of concern, in particular as they arise due to the nature of the production and sourcing of agricultural and natural resource products.

To document the diverse environmental implications of different commodities, the World Wildlife Fund (WWF) has identified 15 commodities that have the largest environmental impacts (palm oil, cotton, sugar, beef, etc.). For each of these commodities, WWF is developing specific environmental standards. It has found that the 100 largest companies purchasing these commodities control more than half the market and hence are particularly well placed to play a powerful role in forcing the adoption of rigorous environmental standards by commodities producers around the world. This fact makes these companies' sourcing policies among their most important corporate social responsibility initiatives. The WWF is working with many of these companies to promote responsible sourcing practices.

In many cases, consumer demand can play a strong role in promoting environmental responsibility in such products as timber, coffee and other agricultural products. Despite this consumer interest, company CSR reports frequently ignore commodities sourcing policies and practices.

Human rights violations—such as labor exploitation, labor trafficking and slavery—are systemic in many commodities-related industries including agriculture and mining. These human rights issues are part of larger concerns connected to poverty and corruption and need to be elevated to a prominence equivalent to that of environmental issues. Currently even the large companies that are leaders in focusing on human rights only monitor their first-tier suppliers, and standards such as Fair Trade often don't surface issues such as child labor. Nevertheless there is increasing attention paid to the issue. Increasingly, the right questions are being asked and there is hope for convergence around credible standards.

Long-term trends among institutional investors will influence the amount of attention paid to these issues. The behavior of these investors with billions of dollars under management is important, as is project finance by international agencies, though the relative uptake of environmental and social issues by investors remains an open question. For example, a question was raised as to whether American companies and investors lag their European peers on managing ESG issues in commodities investment. And, for all the potential investor impact, commodities markets are driven in large part by population trends and the demands of economic development.

ESG issues might work their way into the institutional investment process in a variety of ways, but the field, in terms of responsible investment, remains relatively underdeveloped. For instance, one potential model is that of the creation of socially responsible commodities indexes created along the model of the SRI stock indexes. But the

pricing of commodities futures depends on a variety of specifics including the geographical location of the commodity and the quality of its physical state, and any assessment of the commodity's environmental and societal implications would need to take into account the records of various intermediaries on the road to market— including but not limited to the complex world of extractive and refining company practices.

Beyond the technical question of index construction, institutional investors tend to be hampered on the social and environmental aspects of commodities investments by the simple fact of not knowing the right questions to ask. Similarly, their investment consultants, on whom they rely for guidance and information, are not likely to have substantive knowledge of or interest in these topics.

One suggestion that emerged from discussion was the development of a framework within which to evaluate responsible commodities investments—a series of hard questions against which potential investment decisions could be tested. One obvious avenue is that of third party certification. Being able to rely on certification frameworks established by international or national regulation, or shared industry standards, could be particularly useful in this regard. For example, FSC certification for forestry is useful (Europe requires imports to be FSC certified) and in the real estate asset class LEED certification has helped responsible investors qualify projects for their investment. At the same time, however, there is a need for investors to move from a compliance mentality to proactive stewardship. Environmental and human rights evaluations need to become part of the investment due diligence process, because there is an inherent risk of missing substantial implications of these issues if investors think of commodities as an abstract investment and don't understand the supply chains involved.

Trading and Speculation in Commodities as an Asset Class

Financial innovation plays a particularly prominent role in commodities investments; as a result, investors must pay special attention to evaluating the nature of financial innovation and complexity in the asset class. Not all innovations deliver long-term financial or social benefits. Perhaps more than other financial markets, the commodities markets are prone to speculation. That is to say, those investing in commodities futures with no intention of delivering or receiving delivery of the actual commodity are making a speculative bet on the direction of that commodity's price. In effect, if you're not a commodities producer or consumer then you are a speculator, even if that is as a long-term speculator. Passive commodities indexers are trend followers and may contribute to speculative bubbles, even as they remain ignorant, at times, of the constituent elements of their portfolios.

As a result, speculative activity can cause problems in the commodities market by distorting its function of sending price signals to producers. Significantly, prices can move more rapidly than producers can respond to price signals. Investment markets in agricultural commodities may operate at one or several steps removed from the natural

cycles that dictate production cost and capacity with detrimental impacts on producers or may communicate signals that don't reflect functional demand.

Agricultural commodities futures markets were established to help producers hedge risks and establish stable prices where farming cycles and weather conditions are variable. In keeping with this smoothing out function, after the Depression there were limits on agricultural futures contracts. The Commodities Markets Futurization Act loosened these restrictions in 2000 by dramatically increasing contract limits, and commodities markets have been increasingly volatile since then.

There are also many agent/principal conflicts within commodities markets. Compensation schemes for commodities traders can amplify markets on both the up and the down sides. When prices rise, traders' demand increases, rather than decreases as it would for consumers. In addition, pension funds and other institutional investors, perhaps because of the newness of the asset class, tend to be homogenous in their investment philosophies on commodities and adopt similar strategies simultaneously.

To overcome these conflicts, institutional investors need more transparency from their fund managers to better determine to which trading strategies they are exposed, the full range of fees and costs embedded in their transactions, what collateralization practices are used for leveraged investments, the extent of counterparty risks, and so on.

Other structural conflicts are also important to understand. For example, investors need to know if investment banks from whom they are purchasing commodities-based products are also owners of warehouses for specific commodities, fuel farms, or other commodities storage capacity that could give the banks an edge in their knowledge of the markets.

Analysts still debate whether price volatility in commodities futures markets actually affects spot prices. One concern here is that commodities as a whole are a relatively small asset class. Institutional investors making an asset allocation to commodities may perceive their allocation as small (e.g., 5% of total assets) relative to their overall portfolio (e.g., $200 billion). But if numerous institutional investors are all making the same allocation, the absolute dollar amounts pouring into the commodities markets can be large relative to the size of these markets, which are only a fraction the size of equities or fixed-income markets. These relatively huge inflows can have outsized impact on market movement.

One debate has centered particularly on food commodities. The question here is whether the rapid increase in institutional investments in commodities indexes, which include food items, drives up both the futures and spot prices for these food stuffs and ultimately has the potential to make them unaffordable for the poor around the world. In theory, futures prices don't necessarily affect spot prices. However, spot prices in commodities markets can be set in relation to future prices in various circumstances. Although theoretically spot prices driven to irrational highs by futures or other mechanisms will ultimately self-correct, the time required for markets to fall back into alignment may

not be consistent with real food requirements. Moreover, false signals can be sent to farmers by bubbles in the agricultural futures markets, as well as for producers in other commodities markets. Investors should be aware that bubbles in different commodities have different implications, some (e.g., wheat) more serious than others (e.g., copper) from a societal point of view.

Moreover, some of the basic premises for allocation to commodities as an investment asset class are becoming questionable. Commodities are becoming more correlated to other asset classes, undermining the diversification argument. Those commodities that are hard assets can in theory be used as an inflation hedge, but that is less and less true in practice. Many commodities are becoming increasingly volatile, making arguments for commodities as a risk reduction mechanism increasingly questionable. There are still correlation diversification benefits if investors focus on a single commodity, and shorting can help hedge some risks, but if investors take a basket approach to the asset class these benefits tend to be neutralized.

The most effective and responsible way of investing in commodities may be to own the means of production, not the fruits of production. Then investors have the potential to contribute to positive solutions, and limit their role in price manipulation. When investors invest in the producers of commodities, rather than indexes or futures, they have a greater opportunity to ask hard questions and to confront social and environmental implications of their investment. And investments in the equities of commodities producers may actually, and counter-intuitively, turn out to be less correlated to the equities market as a whole than investments in the commodities themselves.

Investing in Sustainable Hard Assets

Opportunities for institutional investors to invest in those hard assets in the commodities markets that have particular positive social and environmental outcomes focused on two examples in particular.

The first, a sustainable forestry project in Ecuador, is 100% community owned and has as two of its principal goals the preservation of diverse tropical forests and the creation of sustainable local economies. Timber species in the forest were surveyed to determine their usefulness and marketability and markets were then identified and developed for products of the timberland. The important indicators here are not necessarily FSC certification, but rather the embodiment of certain social and environmental values in the governance and business model of the enterprise.

The tough questions to ask are whether community members are involved and whether the business model embodies social and environmental sustainability. The crucial story on this particular project in Ecuador is the value it creates for the local community. The MacArthur Foundation, one of the lenders to this project, asks for detailed measurements of the social and environmental benefits of the project and provides feedback on their adequacy.

Building these values into the business model is a challenge when the project has to compete against others, as is the case in the rapidly expanding market for palm oil. The business factors driving palm oil's expansion and the accompanying deforestation are powerful. While work has been done to help assure that sustainability factors are included in palm oil production by the Roundtable on Sustainable Palm Oil, which is now applied to 10% of the world's palm oil market, the relentless destruction of forests by the palm oil trade continues apace.

A question was raised as to whether institutional investors would be willing to take the time or incur the expense necessary to do the due diligence to assure that a project had particularly strong social and environmental benefits and whether such research could be justified as a legitimate part of the due diligence expense.

A second example came from a European asset manager that has raised a sustainable agriculture fund for investment in Sub-Saharan Africa. It invests in sizeable pre-existing agricultural estates ($7-$10 million per investment). The goal is to lease the land to local farmers, improve its quality and production capacity, train farmers and estate managers, improve the wellness and wellbeing of the local community, and develop domestic and foreign markets for products, with a goal of returning the land to local ownership after a ten-year period.

The fund's managers measure and report on various social and environmental metrics that quantify the non-financial returns of this project, although there is no single framework for doing so. They work with an external an external SRI research firm for measurement of the social and environmental indicators.

This example highlighted the challenges of social and environmental metrics, their utility and practicability. If there is a substantial appetite for these indicators among large institutions investors, why haven't they already been developed? And how is it possible to ensure that what gets developed measures real benefit? These challenges are aggravated by the typical beliefs of investment bankers and consultants that other products that they are marketing are best for institutional investors, their disregard for social and environmental impact, and the culture that they have created in which complex products are not questioned or even fully understood by supposedly "sophisticated" investors.

Investors, especially large asset owners such as pension funds, may have more power in these situations than they realize, but it remains difficult to understand how to empower them to break free of some current habits. They have become used to containing their due diligence to financial returns, avoiding basic questions about how their investments relate to the real economy. The idea of a "devil's advocate" available to assist trustees in raising hard questions about the impacts in the real world of their investments came up in this context. In the Netherlands, for instance, the pension fund supervisory authority is now asking tough questions about the degree to which institutional investors fully understand the nature of their investment decisions. Perhaps the United States would benefit from some kind of

"underwriter's lab for financial innovation" that could establish best practice for transparency, the appropriateness of new financial products, and could assess the potential of new financial products to do good or do harm. Commodities may offer a particularly useful starting point for these conversations, given their often profound and tangible social and environmental impacts.

Possible Next Steps

A series of concluding thoughts on possible next steps was solicited from the group. They included the following.

- Map the current state of social and environmental metrics and standards for commodities.
- Conduct a study of the agent/principal problems involved in commodities investments.
- Prepare a background paper on what a financial oversight agency would look like that would rule in advance on the possible dangers of new financial products.
- Construct a range of hypothetical portfolios for responsible investors interested in the commodities asset class.
- Identify authoritative persons who can speak for responsible commodities investment and promote a wider debate on the issue.
- Prepare a list of "myths" about commodities investment that need to be debunked, spelling out the risks of irresponsible investments in this asset class.
- Encourage the development of standards for the commodities asset class that can be readily understood and easily implemented. Eliminate some of the complexity that's creeping into evaluations of this asset class.
- Write a background paper that would clearly state what the legitimate reasons are for investing in this asset class and what are not, as a means of educating investors about their options and how they can better understand these investments.
- Devise a plan for identifying academics in the finance departments of business schools potentially interested in this topic and place in their hands materials that would grab their attention and highlight key issues.
- Develop a clear and consistent message on investments in commodities that could be adopted by the NGO world, including a set of metrics that could be agreed upon as fundamental.
- Assemble a commodities investment tool kit that could be made available to institutional investors and their trustees.