

Reuters/Jefferies CRB IndexSM

The definitive commodities benchmark



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The case for commodities

Demand for commodity index-linked investment products from both institutional and retail investors has grown considerably over the past several years. Commodities as an asset class possess several key strategic characteristics that may be advantageous to investors over sustained periods. Unlike stocks and bonds, commodity prices historically demonstrate a positive correlation with inflation, providing superior returns in rising interest rate environments. Commodity returns demonstrate low to negative correlations with those of equities and bonds.

As a traditionally non-correlated asset class, commodities have offered investors a valuable source of portfolio diversification. Over long-term horizons, commodities have demonstrated average returns comparable to those from equities. Investments in US Dollar-denominated commodities can act as an effective hedge to currency exposure. Adding commodities to a traditional portfolio of equities and fixed income products may improve returns in absolute and risk-adjusted terms.

Obtaining exposure to commodities

Physical commodity market investments are impractical for most investors due to the complications associated with owning the physical goods. For example, buying, storing and selling physical barrels of oil, bushels of corn or bags of coffee is logistically challenging and requires specialized product knowledge. Investors can instead obtain exposure to the asset class via a range of commodity-linked financial products. These include futures contracts, stocks in commodity producing companies and investments in actively managed commodity investment pools.

However, these vehicles present challenges for investors,

- Investing with futures requires specific trading expertise and continual maintenance
- stocks of commodity-producing companies are subject to broad stock and bond market movements and may have imperfect correlations with commodity prices, and
- actively managed commodity investment pools depend entirely on manager skill.

Commodity indices may provide a simple and efficient way of acquiring exposure to the asset class. These indices are baskets of exchange-traded futures contracts representing long-only positions in underlying commodities. Indices are systematic, transparent and governed by previously specified calculation methods.

Benchmark commodity indices typically include a variety of commodity sectors to provide investors broad exposure to commodities as an asset class and free the investor from the complex mechanics of futures trading. Investors can attempt to replicate a commodity index by buying proportional amounts of all the underlying commodity futures contracts included in the commodity index of choice and then rolling, re-balancing (as required) and reweighting (as required) the basket of futures according to specified calculation methods. Direct investment in commodity futures requires expertise and exposes the investor to the risk of significant tracking error. Thus, many investors will find it more efficient to invest in a commodity index fund that aims to replicate the performance of a chosen index.



Commodity index-linked exchange traded funds, or ETFs, allow investors to access the returns of a designated commodity index with low levels of tracking error via liquid financial instruments listed on stock exchanges. ETFs provide simplicity and flexibility: investors are able to obtain index exposure in one transaction, carried out on an exchange and at real time prices, making it possible to react quickly to market movements. Investors can also take advantage of short-selling. Because ETFs meet market-making requirements on their respective stock exchanges and are continuously quoted throughout the sessions, they provide liquidity and transparency. ETFs are cost effective: most funds do not have subscription or redemption fees (although normal brokerage fees typically apply) and fund management fees are competitive in relation to other commodity index-linked investment products.



Data Source: Bloomberg

Date Range: 5/30/97 to 5/30/07

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About the Reuters/Jefferies CRB Index

For nearly 50 years, the CRB Index has served as the most widely recognized measure of global commodities markets. The history of the CRB Index dates back to 1957, when the Commodity Research Bureau constructed an index that made its inaugural appearance in the 1958 CRB Commodity Year Book.

Since then, as the world economy has evolved, the Index has undergone periodic updates to remain a leading benchmark for the performance of commodities as an asset class. The Index was renamed the Reuters/Jefferies CRB ("RJ/CRB") Index in 2005 when it underwent its tenth and most recent revision to maintain its continued accurate representation of modern commodity markets.

The RJ/CRB Index is designed to provide timely and accurate representation of a long-only, broadly diversified investment in commodities through a systematic, transparent calculation methodology. Members of the investment and academic communities along with central banks and prominent non-governmental organizations use the RJ/CRB Index as the definitive benchmark for price levels and movements within the commodities markets.

The RJ/CRB Index is widely quoted and referenced in leading print media sources such as the New York Times, Wall Street Journal and Financial Times and broadcast media outlets such as CNBC, CNN, FOX and Bloomberg Television. Respected academic white papers on the subject of commodity investing - such as The Tactical and Strategic Value of Commodity Futures and Facts and Fantasies about Commodity Futures highlight the RJ/CRB Index.

Included commodities and weightings

Reuters/Jefferies CRB Index maintains broad diversification through 19 commodities representing all commodity sectors – energies, base metals, precious metals, livestock, grains and softs. In determining starting annual weights for component commodities, benchmark indices employ differing approaches. The RJ/CRB Index employs equitable distribution wherever feasible while re-weighting exposure to selected markets, such as the economically important energy sector. The index is designed to be liquid and rational.

The Reuters/Jefferies CRB Non-Energy Index is designed for investors seeking broad exposure to commodities excluding energy. This liquid index maintains diversification through 15 commodities representing 5 major sectors – base metals, precious metals, livestock, grains and softs.

RJ/CRB Index target weightings by sectors:

Sectors	
Energy	39%
Grains & Softs	34%
Base Metals	13%
Precious Metals	7%
Livestock	7%

RJ/CRB Non-Energy Index target weightings by sectors:

Sectors	
Grains & Softs	55.7%
Base Metals	21.3%
Precious Metals	11.5%
Livestock	11.5%

Index basics

Commodity indices are governed by specific calculation methods. As such, creating a commodities index requires that critical decisions be made concerning three categories of issues: included commodities and weightings, re-balancing methodology and rollover methodology. Decisions on these three issues significantly determine commodity index performance and distinguish the indices from one another.

Re-balancing methodology

The RJ/CRB Index rebalances monthly to its target weightings. Monthly re-balancing helps maintain the stability and basic composition of the index over time, preventing sector and component drift from sustained relative price movements. Re-balancing has also been suggested as a means of increasing the risk-adjusted returns of a diversified commodity portfolio. Periodic re-balancing of a collection of uncorrelated and mean-reverting assets can increase total returns and lower index volatility. Through the re-balancing process the RJ/CRB Index systematically decreases exposure to commodities that have trended higher in value and increases exposure to those commodities that may be relatively inexpensive. To the extent that commodity prices are mean-reverting, this regular re-balancing can be a source of positive alpha. By re-balancing its component weightings monthly, the RJ/CRB Index increases transparency for investors and mitigates the timing effects to which less frequency rebalanced indices are exposed.

Rollover methodology

The RJ/CRB Index uses a four day rollover schedule for each commodity beginning on the first business day of the month and ending on the fourth business day. All liquid calendar months for every commodity are included in this rollover schedule. The rollover methodology assumes a constant dollar investment and rolls a proportionally equal amount of the active contract to the deferred month contract at the end of each roll day. The choice of a rollover methodology is critical to the long-term performance of a commodity index.

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The Tactical and Strategic Value of Commodity Futures Claude B. Erb & Campbell R. Harvey, 2006