

Natural Selection

WHEN INVESTORS LOOK TO GET EXPOSURE TO COMMODITIES, many choose to invest in commodities futures contracts. Last year, more than \$62 billion flowed into commodity futures, according to Barclays Capital, and by the end of December, assets under management totaled \$354 billion. By contrast, \$7.6 billion flowed into natural resources private equity last year, while just \$3.7 billion went into publicly traded natural resources equities.

Research analysts and investment managers at RS Investments in San Francisco argue that investors would be better served by redirecting their commodities allocation to natural resources stocks. Not surprisingly, RS Investments manages \$3.5 billion in natural resources equities. Their argument is that because of fundamental changes in the commodities markets over the last ten years, commodities futures have not and will not provide the portfolio diversification benefits historically attributed to commodities and that natural resources stocks are a better bet for keeping up with long-term inflation.

Investors have gravitated toward commodities in the last ten years for numerous reasons. Among the most important are portfolio diversification, inflation protection and positive long-term views on commodity prices and future returns. As the flow of funds demonstrates, when given a choice between commodities futures, public equity and private equity, investors have put their money in commodities futures.



Conventional wisdom is that natural resources stocks do not provide the diversification benefits of commodities futures. They are stocks, after all, and have a high equity market component, notes Christian Busken, director of real assets at investment consultant Fund Evaluation Group in Cincinnati. Moreover, many natural resources companies are involved in multiple lines of business and their stock introduces management risk into the commodities equation. The thinking is that commodities futures are a better “pure play.”

Data indicates, however, that natural resources funds are not perfectly correlated to the broad stock market. Natural resources funds have an average R-squared (the percentage of their movements that can be explained by S&P 500

Are futures or natural resource equities the best way to get commodity exposure?

By Virginia Munger Kahn

movements) of 69 versus 89 for the average domestic stock fund and 91 for the average global stock fund, according to Morningstar data. Moreover, management risk can be a positive factor. In the ten years ended December 2010, natural resources stocks far outperformed commodity indices. The MSCI World Commodity Producers Index returned a cumulative 204.5% versus 19.18% for the S&P GSCI Total Return index, according to data provided by RS Investments.

Operating leverage for producers of commodities and fundamental changes in commodities futures markets are responsible for those results, said RS Investments in a recent white paper titled, "Institutional Real Asset Strategies." These changes undercut arguments for investing in commodity futures and bolster arguments for the outperformance of natural resources stocks going forward, according to the firm.

One major change is that the correlation between commodity and equity returns has increased in the last ten years. This increased correlation is particularly problematic in down equity markets when investors need diversification most.

assumption that commodities are more effective diversifiers than natural resources stocks is simply wrong," says Ken Settles, co-manager of the RS Global Natural Resources Fund, which has \$2.6 billion in assets. The fund is down 0.13% this year versus a gain of 1.52% for the S&P 500. Over the last ten years, the fund has returned 14.69% annualized versus 2.36% for the S&P 500.

Settles argues that rising correlations are the result of the elimination of spare capacity for many commodities, which characterized the 1970s and 1980s, and that changes in demand now influence pricing. While supply shocks can still send commodities soaring and equities reeling, commodities and equities now march to the same drummer—global economic growth.

Meanwhile, the rising marginal cost of supply—as companies dig deeper or go further afield to find natural resources—has resulted in expectations that commodity prices will rise. This has been reflected in the shape of commodities futures curves, which in the last ten years have become upward sloping. That means that futures contracts closest to

nualized from commodities futures returns. By contrast, during the 1970s, roll yields added 4.62% annually to returns. "Roll yields have been declining for the last four decades," as spare capacity has shrunk, Settles asserts. "This is not just a blip, but a change in fundamentals."

Finally, Settles argues that natural resources stocks have shown almost as much sensitivity to changes in the rate of inflation as commodities have over the last ten years. From 2001 through 2010, the correlation of annual percentage changes in the S&P GSCI and the S&P North American Natural Resource Sector versus the CPI were 0.76 and 0.73, respectively. This undercuts the argument for commodities as a superior inflation hedging tool, says Settles.

But correlations are not the whole story. It comes down to the difference in returns, Settles says. Fund Evaluation Group's Busken notes that several years ago he found that only nonrenewable commodities such as oil, gas and gold keep pace with inflation over the long term. Between 1951 and 2003, while the CPI increased 598%, the spot prices of most commodities, including silver, copper and many agricultural commodities, fell far behind. Investors need to be selective in choosing their inflation hedges, he says.

Busken is a proponent of private equity exposure to commodities such as energy exploration and development partnerships. "If you can handle the illiquidity, private equity is the best way to go for long-term investors," he says. Not only should investors earn a premium for locking up their money, but generally they're getting direct ownership of the commodity.

Other investment managers also favor equities over futures in a commodity allocation. The headwind to returns posed by upward sloping futures curves is "just a killer," says Ben Inker, the head of asset allocation at Grantham Mayo Van Otterloo in Boston. "If you're going to get exposure, it's better to own the companies that produce the commodity," he told a Morningstar Investment Conference panel in June. GMO's Jeremy Grantham has been an outspoken proponent

RESEARCH ANALYSTS AND INVESTMENT MANAGERS AT RS INVESTMENTS IN SAN FRANCISCO ARGUE THAT INVESTORS WOULD BE BETTER SERVED BY REDIRECTING THEIR COMMODITIES ALLOCATION TO NATURAL RESOURCES EQUITIES.

In 2008, when the S&P 500 was down 37%, the S&P GSCI Total Return was down 46.5%. In 2001, when the S&P 500 was down 11.9%, the GSCI was down 31.9%. Natural resources stock funds were down 48.8% and 10.4%, respectively, in those two years.

"In each downturn since 1998, commodities were highly correlated with equities. When you look at the data, the

expiration are priced lower than contracts further out on the curve. When investors roll from the nearest, cheaper contract to the next, more expensive contract, they lose money on the roll.

In contrast, downward sloping futures curves, in which investors roll from more expensive to cheaper contracts, help returns. During the 2000s, negative roll yields subtracted almost 8% an-

of long-term investing in commodities, despite the near-term risk of a sell-off due to a decline in the Chinese economy. Noting that commodity futures give investors simple price exposure, Inker noted, “With equities, you get a return.”

Similarly, Richard Fullmer, an asset allocation strategist at T. Rowe Price Associates in Baltimore, says that the uncertainties surrounding roll yield, as well as the firm’s experience analyzing natural resource equities, has led his group to advocate for the use of “real asset equities,” which include real estate and infrastructure stocks, in the firm’s portfolio products. “For many years, there was an advantage to buying futures,” says Fullmer, “but it is unclear now whether the turn to negative roll yields is cyclical or more structural. The returns investors can expect from futures to us is uncertain,” he says.

Still, other advisors and strategists continue to favor commodities futures as a better pure play on commodities prices as well as a better inflation hedge.

Steve Jones, a principal in the manager research group at Mercer Investment Consulting in Chicago, notes that the correlation of returns between the GSCI, which has a large energy component, and the S&P energy sector is not that high. Since 1989, the rolling monthly correlation between the S&P energy sector and the GSCI has been 0.53. “At only about 50%,” says Jones, “equities are not the best way to get exposure to commodities. We prefer direct exposure to commodities futures.”

Moreover, while both the GSCI and the S&P Natural Resources Index have been highly correlated with the CPI in recent years, the GSCI has a higher correlation—0.75—to the CPI on a one-month lagged basis than does the natural resources index—0.50. For example, the total return of the GSCI in January was highly correlated with the CPI in February. That makes sense given that the GSCI feeds almost directly to the CPI, notes Jason Thomas, chief investment officer at Los Angeles-based wealth manager Aspiriant.

Thomas notes that Aspiriant uses all three methods of gaining exposure to

commodities—futures, public natural resources stocks and private equity. Natural resources stocks have important sources of return that are not captured in the inflation measures, he says. However, commodities futures are the way to go for investors looking to hedge unexpected price inflation. “We use futures as the

firm Barclays expects to see correlations between equities and commodity futures head down again as the risk-on/risk-off investing following the financial crisis dissipates and fundamentals again predominate in the markets. Ted Wright, director of portfolio management at Genworth Financial Asset Management

AS THE FLOW OF FUNDS DEMONSTRATES, WHEN GIVEN A CHOICE BETWEEN COMMODITIES FUTURES, PUBLIC EQUITY AND PRIVATE EQUITY, INVESTORS HAVE PUT THEIR MONEY IN COMMODITIES FUTURES.

purest form of exposure to unexpected increases in spot prices,” he says.


He and others also note that tweaking passive approaches to managing commodities futures can minimize issues associated with upward sloping futures curves. In 2006, Aspiriant asked Goldman Sachs to build an enhanced commodities futures index designed to deal with the drawbacks in the benchmark. Goldman then issued an exchange-traded note based on the enhanced index to which Aspiriant has directed \$100 million in client assets.

Among the modifications: The index rolls futures contracts seasonally when futures curves are downward sloping; the index rolls futures contracts that are five and six months out on the curve versus one and two months out; and the index rolls short-term contracts before the major indexes. These tweaks have added 4% annually to the index’s performance versus the GSCI. While the GSCI is down 4.25% since July 2007, when the enhanced index was created, the ETN is up 0.12%.

Some market players also expect commodity prices to reassert their independence from the equity markets in the coming months. Investment banking

in Encino, Calif., agrees. “I can tell you if oil goes higher and detracts from GDP, you will get a separation in correlation between the equity markets and oil,” he says. The firm prefers to use managed futures to take advantage of the “trendiness” in commodity markets. “Our expectation is that managed futures will provide good diversification benefits,” says Wright.

Many advisors believe commodities futures deserve a place in portfolios as a hedge against event risk such as geopolitical instability and weather-related disruptions. “You don’t really know when these events are going to happen, but by having a little bit of commodities exposure, you’ll get some protection,” says Busken.

RS Investments’ Settles agrees that the futures markets are more effective at hedging against short-term shocks in supply. But ultimately, the question of how effective asset classes are in protecting investors from inflation gets back to returns, he says. Given the headwinds commodity futures investors face as a result of negative roll yields, “we believe natural resources equities are more effective in protecting investors against long-term increases in commodities price inflation,” he says. 

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RS Global Natural Resources Fund (RSNRX) Performance [†] (Average Annual Total Returns as of 9/30/11)				
	1 Year	5 Year	10 Year	Since Inception (11/15/95)
RS Global Natural Resources Fund, Class A				
without sales load	-2.35%	3.14%	15.20%	9.96%
with maximum sales load	-7.00%	2.14%	14.63%	9.62%
S&P North American Natural Resources Sector Index ^{TM1}	-1.63%	3.18%	10.10%	n/a
MSCI World Commodity Producers Index ²	-4.42%	2.66%	10.32%	n/a
S&P 500 [®] Index ³	1.14%	-1.18%	2.82%	6.03%

Performance returns for periods of less than one year are not annualized.

Sector Allocation ⁴ (As of 9/30/11)	
Energy	52.62%
Materials and Processing	39.87%
Utilities	3.70%
Financial Services	1.19%
Cash	2.61%

Top Ten Holdings ⁵ (As of 9/30/11)	
Occidental Petroleum Corp.	5.22%
Southwestern Energy Co.	5.18%
Range Resources Corp.	4.77%
Denbury Resources, Inc.	4.76%
Martin Marietta Materials, Inc	4.75%
Compass Minerals International	4.62%
Goldcorp, Inc.	4.61%
Antofagasta PLC	4.57%
Talisman Energy, Inc.	4.16%
Oil Search Ltd.	4.02%

[†] Performance quoted represents past performance and does not guarantee future results. Investment return and principal value will fluctuate, so shares, when redeemed, may be worth more or less than their original cost. The Fund's total gross annual operating expense ratio as of the most current prospectus 1.50% for the Class A shares. Class A performance quoted "with maximum sales charge" reflects the current maximum sales charge of 4.75%. Please read the prospectus carefully for more information on sales charges as they do not apply in all cases and if applied are reduced for larger purchases. Certain share classes are subject to lower maximum sales charges whether paid at the time of purchase or deferred. Any sales charges are in addition to the Fund's fees and expenses as detailed in the Fund's most current prospectus. Fees and expenses are factored into the net asset value of your shares and any performance numbers we release. Total return figures reflect an expense limitation in effect during the periods shown; without such limitation, the performance shown would have been lower. Performance results assume the reinvestment of dividends and capital gains. The return figures shown do not reflect the deduction of taxes that a shareholder may pay on Fund distributions or the redemption of Fund shares. Current and month-end performance information, which may be lower or higher than that cited, is available by contacting RS Investments at 800-766-3863 and is frequently updated on our Web site: www.RSinvestments.com.

¹ The S&P North American Natural Resources Sector IndexTM is a modified cap-weighted index designed as a benchmark for U.S.-traded securities in the natural resources sector. The index includes companies involved in the following categories: extractive industries, energy companies, owners and operators of timber tracts, forestry services, producers of pulp and paper, and owners of plantations. Index results assume the reinvestment of dividends paid on the stocks constituting the index. Unlike the Fund, the index does not incur fees or expenses.

² The MSCI World Commodity Producers Index (MSCI-WCP) is an equity-based index designed to reflect the performance related to commodity producers stocks. The MSCI World Commodity Producers Index is a free float-adjusted market capitalization-weighted index comprised of commodity producer companies based on the Global Industry Classification Standard (GICS[®]).

³ The S&P 500[®] Index is an unmanaged market capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Index results assume the reinvestment of dividends paid on the stocks constituting the index. You may not invest in the index, and, unlike the Fund, the index does not incur fees and expenses.

⁴ The Fund's holdings are allocated to each sector based on their Russell classification. If a holding is not classified by Russell, it is assigned a Russell designation by RS Investments. Cash includes short-term investments and net other assets and liabilities.

⁵ Portfolio holdings are subject to change and should not be considered a recommendation to buy or sell individual securities.

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