RIVERFRONT INVESTMENT GROUP

Strategic View

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SUMMARY

- Investing in commodities can provide increased diversification to the traditional 60/40, in our view.
- Direct commodity investing can be complex and provides no regular cashflows.
- We believe that investing in commodity-levered equities is preferable in the current environment.

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Why We Prefer Investing In Commodity Stocks Rather Than Direct Commodities

Following 2022, a year which saw the worst return for a '60/40'* balanced portfolio since 1942, it is natural for investors to begin looking for an alternative to stocks and bonds. Through this search for alternative asset classes, several of our clients have approached us with questions regarding commodity investing. While commodities are a common subject in the media, investing in them requires different analysis than stock and bond investing. We would like to discuss our current views on commodity investing in this *Strategic View*.

* *We define '60/40' here as a portfolio comprised of 60% Large Cap US stocks and 40% 10-year US treasury bonds.*

Diversification Benefits of Commodities

The primary benefit to commodity investing, in our view, is diversification. The commodity space contains four major sectors: energy, agriculture, industrial metals, and precious metals. A diversified basket of these commodities tends to have long term returns that differ from stocks and bonds. Below is a table of daily return correlations** between the price returns of US large cap stocks, US bonds, and commodities, looking back over the past twelve months.

*** We define correlation here as the degree to which two sets of price data are related to one another; for instance, a correlation close to 1.0 would imply an extremely strong relation, meaning that those two investments would have returns of similar magnitude for any given period, while a low correlation close to 0.0 would imply close to no relationship, meaning their returns are unrelated, in our view.*

	Correlations Between Daily Returns Over the Past Year		
	US Large Cap	**US AGG**	**Commodities**
US Large Cap	1.00	**0.28**	0.14
US AGG	0.28	1.00	0.09
Commodities	**0.14**	**0.09**	1.00

Source: Bloomberg. Data daily as of February6, 2023. Shown for illustrative purposes only. Past Performance is no guarantee of future results. In the above chart, ETFs are used to replicate benchmark indices and is for informational purposes only.

Over the past year, commodity investments have had a low correlation to both bonds and stocks. This low correlation can be seen in the table above. For example, commodities are only slightly correlated to the S&P 500, which can be seen with the 0.14 correlation ratio. Importantly, this correlation is lower than the statistical relationship between stocks and bonds, at 0.28. We believe that this correlation shows that commodities could be another source of diversification in a portfolio of stocks and bonds. Over the past five years, commodities are more closely correlated with stocks than bonds.

Our View: The Four Tradeoffs of Commodity Investing

There are two main vehicles for gaining investment exposure to commodities: direct investment and equity investment. Direct investment in commodities for most people is a bit of a misnomer; most commodity investors are using futures contracts and typically do not take delivery of physical commodities. Futures contracts are preferable to some investors because the delivery and storage of physical commodities requires a lot of logistics and physical space, making it costly for investment purposes. However, this form of investing is distinct from purchasing the stocks of commodity-related companies, whose revenue and earnings are levered to commodity pricing. When deciding between these two investment types, we believe there exist four main tradeoffs that must be considered.

1. **Direct Investment Provides More Diversification.** The first trade off involves the diversification effect of the investments. As can be seen in the table below, both physical commodities and commodity producing equites provide diversification benefits relative to stocks. While direct investments in commodities provide the lowest correlation (0.14) to stocks, it comes with its own set of drawbacks as discussed below.

	Correlations Between Daily Returns Over the Past Year		
	US Large Cap	**Commodity Producers**	**Commodities**
US Large Cap	1.00	0.49	0.14
Commodity Producers	**0.49**	1.00	0.60
Commodities	**0.14**	0.60	1.00

Source: Bloomberg. Data daily as of February6, 2023. Shown for illustrative purposes only. Past Performance is no guarantee of future results. In the above chart, ETFs are used to replicate benchmark indices and is for informational purposes only.

2. **Unlike Direct Investment, Equity Investments can Provide Cash Flows.** Since equity investments are in companies rather than the commodity itself, there is an associated cash flow with these investments that can be analyzed and potentially harvested. In particular, several of these companies return cashflows to shareholders both in the form of dividends and share buybacks, a feature we believe is particularly important in the current investing landscape. On the other hand, direct commodity investments are typically non-cash flow generating. For an investor that needs their portfolio to produce consistent income, this can be a major drawback to direct commodity investing.

3. **Direct Investments Through 'Futures' can be Complicated.** One of the intricacies of direct commodity investing is that it must be done through the futures markets. In its simplest form, a future is the agreement to buy or sell a commodity at a specific price at a set date in the future. What makes futures investing difficult is the fact that futures prices can vary significantly from the current (spot) price of the commodity. In essence, the futures price may have already incorporated a significant rise (or fall) in commodity prices. Therefore, investing in commodity futures may not lead to investment success even if the investor correctly anticipated the direction of the spot price.

4. **Taxes and Structure can be More Complex for Direct Investment.** Since direct investment is achieved using futures, there are tax complications regarding them. Traditionally, Exchange Traded Funds (ETFs) that provided direct commodity exposure require additional tax accounting. This solution can be costly for both the fund and the investor, and we believe should be avoided when possible. Recently, funds have begun to enter the marketplace which are able to avoid additional tax forms. To accomplish this, these funds must be domiciled outside the US and have historically paid out distributions at the end of each year. In addition to the intricacies of offshore investing, these distributions are taxed as short-term gains, making them hard for some investors to accept.

Implications For Our Portfolios

When considering the above tradeoffs, we believe it is important to also consider the context of current market conditions. As we discussed in our 2023 Outlook, we believe that this year will see a market that continues to transition from the era of 'growth' stock dominance to an increased focus on consistent cash flow, dividend, and coupon generators – what RiverFront calls the 'P.A.T.T.Y.' (Pay Attention to the Yield) theme. As such, the tradeoff of cash flows becomes the most important in our investment process. This results in our preference to invest in the stocks of commodity producing companies over direct commodity investing. Specifically, we believe it is important to identify companies in commodity sensitive industries that are capitally disciplined and have healthy balance sheets.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such *as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.*

Important Disclosure Information:

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed.

This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation or need of any particular client and may not be suitable for all types of investors. Recipients should consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.

All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Index Definitions:
Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Bloomberg US Aggregate Bond Index measures the performance of the US investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than one year.

High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

Definitions:
An exchange-traded fund (ETF) is a type of pooled investment security that operates much like a mutual fund. Typically, ETFs will track a particular index, sector, commodity, or other assets, but unlike mutual funds, ETFs can be purchased or sold on a stock exchange the same way that a regular stock can. An ETF can be structured to track anything from the price of an individual commodity to a large and diverse collection of securities. ETFs can even be structured to track specific investment strategies.

Interest rate sensitivity is a measure of how much the price of a fixed-income asset will fluctuate as a result of changes in the interest rate environment. Securities that are more sensitive have greater price fluctuations than those with less sensitivity. This type of sensitivity must be taken into account when selecting a bond or other fixed-income instrument the investor may sell in the secondary market. Interest rate sensitivity affects buying as well as selling.

Principal Risks:
Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

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