Q&A

Real Alpha

Scott M. Beatty
10 Years Experience

Western Asset Management Company
Portfolio Manager, 2002–

Graduate School of Management, U.C. Irvine
Graduate Teaching Assistant, Finance, 2002

RSM EquiCo, Capital Markets Division
Associate Intern, 2001–2002

Air Industries Corporation
Staff/Chief Engineer, 1993–2000

University of California, Irvine, Graduate School of Management, M.B.A.

Bucknell University, Bachelor of Science

Chartered Financial Analyst

In this Q&A, Western Asset ***Portfolio Manager Scott M. Beatty*** *and* ***Product Specialist Joseph A. Filicetti*** *discuss the Firm's Real Alpha strategy. This strategy seeks to exploit structural inefficiencies in commodity forward-pricing curves and seeks to attain excess returns with no commodity beta. Commodity markets have grown tremendously in the last 15 years due to the demand-supply imbalance caused by rapid growth in developing market countries like China and India. Mr. Filicetti and Mr. Beatty explain how the strategy seeks to capitalize on this development without explicit exposure to the commodities themselves.*

Q: What is Real Alpha?

JAF: Real Alpha is a long/short strategy designed for investors who seek uncorrelated excess returns through alternative investments. The strategy has no commodity beta. It captures the spread differential of the forward pricing commodity curves. Excess cash is invested in US Treasuries and is posted as margin for swaps.

Q: How is the alpha generated?

SMB: The strategy attempts to generate excess returns by exploiting structural inefficiencies in the commodity forward pricing curves. Inefficiencies arise as the result of the differences in the time horizon hedging needs of producers, consumers, and passive investors. The growth in commodity investing over the last 10 years has been extraordinary and the buying-and-selling patterns that have resulted from these investments has distorted pricing curves.

Q: Can you explain **contango** and **backwardation**?

SMB: **Contango** refers to the market condition wherein the price of a forward or futures contract is trading above the spot price. Futures contracts for physical commodities typically trade in contango when there is ample supply of a commodity and compensation is paid for carrying costs, such as storage, insurance, spoilage and feeding (in the case of live cattle, hogs, etc.).

Backwardation is the opposite market condition, wherein the price of a forward or futures contract trades below the spot price. It typically occurs when a physical commodity is in short supply and it becomes more profitable to sell inventories in the spot market rather than to store them. This is normally corrected over short time frames and typically occurs when there are droughts, natural disasters, wars, political instability or disease.

Q: How does the strategy take advantage of those shifts?

SMB: Real Alpha takes advantage of the predictable trading patterns, as well as the distorted shape of pricing curves caused by a large amount of long-only investors. The large commodity indices and ETFs use a rules-based rolling schedule to trade futures. Predictably, these investors put downward pressure on contracts they roll out of as the contracts become spot and, likewise, put upward pressure on the contracts they roll into.

JOSEPH A. FILICETTI
25 Years Experience

Western Asset Management Company
Product Specialist, 2010–

Scalae Management, LLC
President and CEO, 2002–2010

CDC Ixis Asset Management
Director, Client Services, 2000–2002

Prudential Securities, Inc.
President and Co-CEO, 1998–2000

Rotella Capital Management
Director, Client Services, 1996–1998

Merrill Lynch Government Securities, Inc.
Proprietary Trader, 1992–1996

Lehman Brothers
Sales Trader, 1986–1990

Columbia University,
M.B.A.

Niagara University
Bachelor of Arts

For example, crude-oil positions in the S&P-GSCI Index are rolled on the fifth through the ninth business days of every month—20% each day. This trading pattern allows Western Asset to take advantage of these inefficiencies. Real Alpha seeks to gain its long exposure from the longer-dated contracts and to take an offsetting short position in the front contracts. Being long and short the same commodity in different delivery months minimizes the commodity exposure (the beta). What is left is the difference in the slopes of the forward pricing curves, which tends to remain constant over long periods. This is the potential alpha.

Q: You mentioned that Western Asset creates its own commodity basket. How is that done, and why?

JAF: The DJ-UBS Commodity Index represents a diversified basket of commodities and includes all major commodity markets irrespective of the shape of the forward curve. It can include markets that typically do not exhibit contango, such as gold and silver.

Western Asset creates its own basket of commodities, similar to the DJ-UBS Commodity Index, but with the goal of optimizing the exposure to those markets that exhibit the greatest contango or relative slope differences. It is our belief that by optimizing our exposure in this way, we can generate more alpha. In addition, Western Asset can change the allocation within the basket to take into account seasonal factors that can also influence the shape of the curve, and hence, optimize the returns.

Q: Why is this strategy relevant in today's environment?

JAF: This strategy has a very low to negative correlation to traditional asset classes such as equities and fixed-income, and is extremely liquid. Also, global commodity markets have grown tremendously due to increases in world population and demand from growing countries, such as China.

Q: As a fixed-income manager, how did Western Asset develop its expertise in the commodity space?

SMB: For almost 10 years Western Asset has been running a passive commodity fund benchmarked to the DJ-UBS Commodity Index. In 2006 we began to investigate ways to outperform the Index and identified a variety of forward-based strategies that tended to do this. In 2008 we decided to isolate the alpha from these strategies and began trading them as a long-short relative value strategy in one of our hedge funds. One of the appeals of the strategy was the low correlation to other asset classes and this consequently contributed to the development of a fund that only focused on this strategy.

Q: What is the greatest risk to the strategy?

JAF: Backwardation is the greatest single risk to a forward-dated strategy like Real Alpha.

Q: How volatile can this strategy be?

SMB: Typically, this strategy has a high Sharpe Ratio, and baskets usually have exposure to 15–20 different commodity markets. Any particular market can have periods of volatility in the forward curves, but over the long term, these periods are relatively short-lived, and the diversification effect of a large basket of exposures helps minimize this risk.

Q: How long do you expect this opportunity to last?

SMB: This opportunity should last as long as there remains a large number of passive long-only investors in commodities who are unable to take delivery of physical commodities and must perpetually roll their long futures positions forward. In essence, these investors are unknowingly financing an excess supply of commodities that don't need to be consumed, which in turn tends to leave the market in a constant state of contango. These factors, along with the increased global demand for commodities that is driving this investment, indicate that opportunities for this strategy should remain attractive.

Q: Where does this strategy fit into a plan's asset allocation?

SMB: This strategy fits well with investors who are looking for liquid, non-correlated returns that can easily be levered to target specific risk-return profiles. It most commonly will fit into an alternative, hedge-fund, opportunistic allocation, within a portfolio allocation framework. It would not be used as a direct hedge against inflation or to give exposure to global commodities.

For more information on this product, please contact the Product Manager, Joseph Filicetti, joseph.filicetti@westernasset.com