Why you need to add “real” commodities to your portfolio
Market overview

David Donora, Head Of Commodities

February 2012

01

Why invest in Commodities?

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What are commodities?

Commodities differ from other capital assets (bonds, equities and real estate)

- Commodities do not generate income and cannot be valued as a NPV of future cash flows
- Commodities are consumable, perishable, and transformable
- A store of economic value
- Traded on a global basis
- Subject to significant supply / demand pressures

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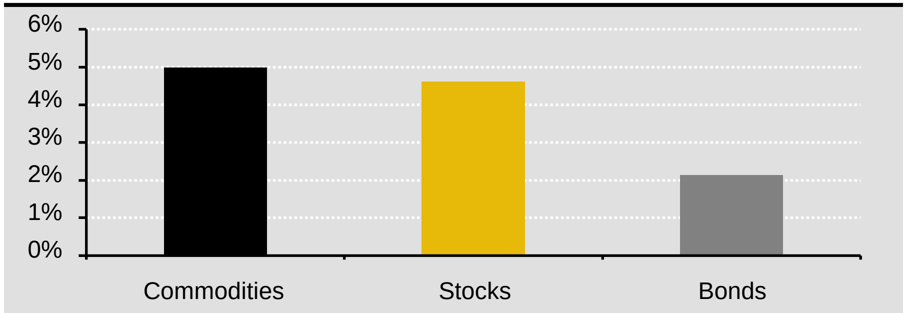
Why invest in commodities?

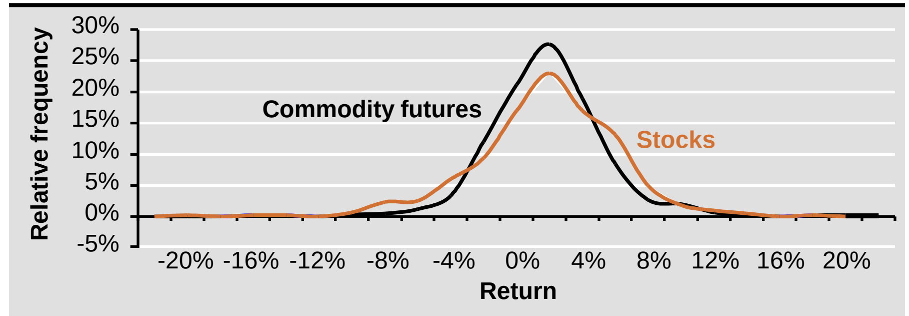
- **Portfolio diversification** – uncorrelated to equities and bonds
- Commodities are positively **correlated to inflation**
- Commodities are a **store of value** against currency debasement
- **Absolute returns** – new ‘super cycle’ with the development of emerging economies and emergence of strong supply constraints in the last decade
- Commodities as a hedge to **geopolitical risk**

Portfolio diversification

Commodities risk premium comparable to stocks and bonds … from August 1959 through June 2009



… yet commodity futures are uncorrelated to equities and skewed points in opposite directions …



Commodities negatively correlated to bonds and positively correlated to inflation over all these time horizons

	Stocks	Bonds	Inflation
Monthly	0.11	-0.10	0.09
Quarterly	-0.01	-0.23	0.29
1-year	0.03	-0.22	0.32
5-year	-0.30	-0.05	0.43

Average returns by stage of the business cycle from July 1959 to December 2007

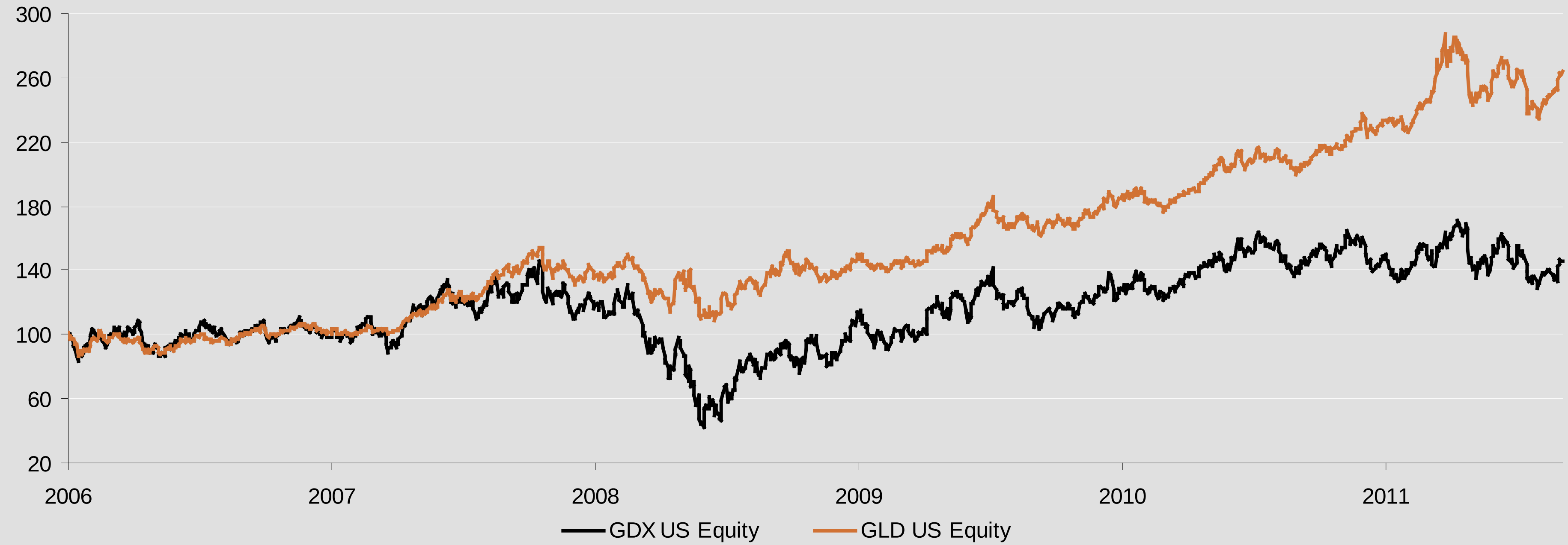
	Stocks	Bonds	Commodity futures
Expansion	12.0%	6.6%	13.1%
Early	13.6%	10.1%	7.5%
Late	10.3%	3.3%	18.8%
Recession	8.3%	15.6%	2.1%
Early	-16.2%	5.8%	3.5%
Late	40.1%	26.6%	0.6%

Source: UBS: Data from July 1959 to December 2004 represents the Equally-Weighted Collateralized Futures Index (as calculated by Gary Gorton and K. Geert Rouwenhorst, February 2005, and described in their paper, Yale ICF Working Paper No.04-20, Facts and Fantasies about Commodity Futures). From January 2005 through June of 2009, this index was constructed by UBS using the same approach as described in this paper and the same basket of commodities as held at the end of December 2004. From July 1959 to December 2008, Stocks are represented by the Ibbotson Large Company Stocks and Bonds are represented by the Ibbotson Long-Term Corporate Bonds Indices. From January 2009 to June 2009, Stocks are represented by the S&P 500 and Bonds are represented by the Citigroup BIG Long Term 10+ Years Index. The risk premium is the average return of an asset in excess of U.S. T-Bills. Historical results should not and cannot be viewed as an indicator of future performance. Source: UBS AG, Bloomberg, Ibbotson Associates; Yale ICF Working Paper No.04-20, Facts and Fantasies about Commodity Futures, Gary Gorton, K. Geert Rouwenhorst, February 2005

Commodities versus Commodity linked equities

GLD versus GDX – the Gold ETF compared to the Gold Miners ETF

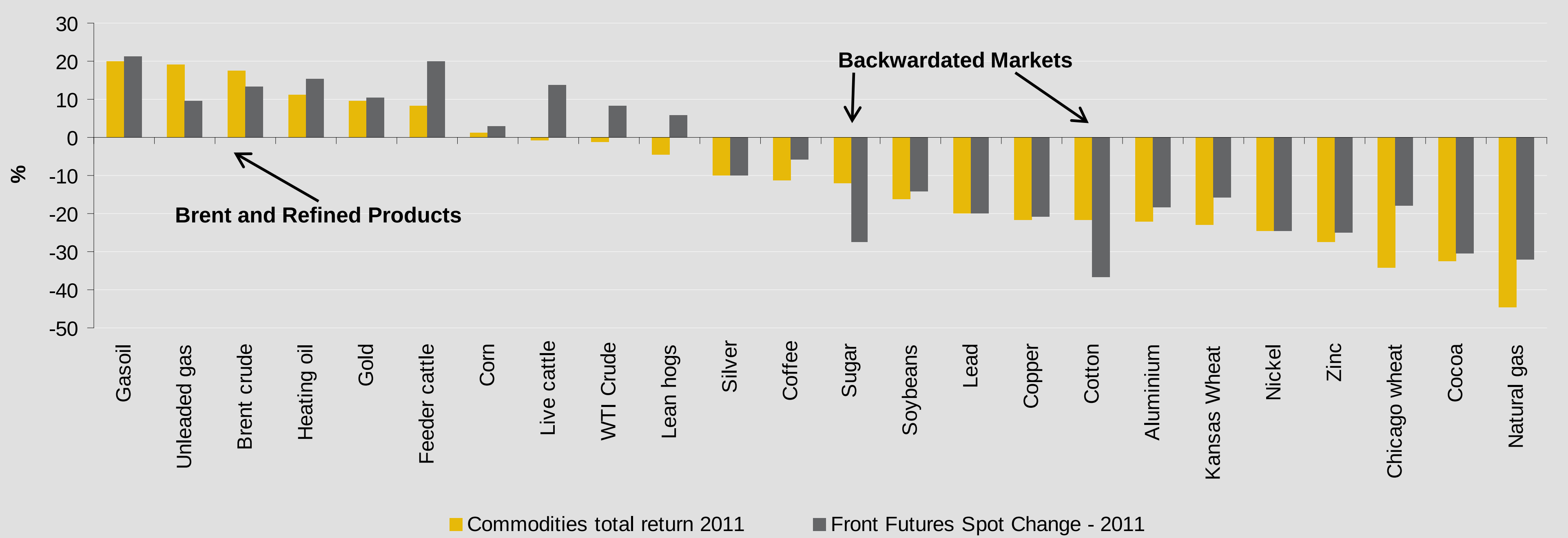
In 2008 and 2011, risk off years, Gold was the safe haven and equities underperformed



Source: Bloomberg, 31 January 2012

Low correlation between individual commodities

Diverse performance amongst commodities in 2011



Source: Standard & Poor's, Bloomberg, December 2011

Commodities as an effective inflation hedge

- High unexpected inflation occurs when the actual rate of inflation exceeds the normal inflation rate given the risk free rate of return[1]
- Periods of high unexpected inflation have occurred approximately 44% of the time since 1960
- Over these periods, excess returns from commodity futures have been significantly higher than equities and bonds

Average excess return over 6-month period from 1960 through 2009

Period	Equities	Bonds	Commodities	% Occurrence
Low unexpected inflation	3.8%	5.1%	0.0%	56.1%
High unexpected inflation	0.8%	-0.3%	6.1%	43.9%

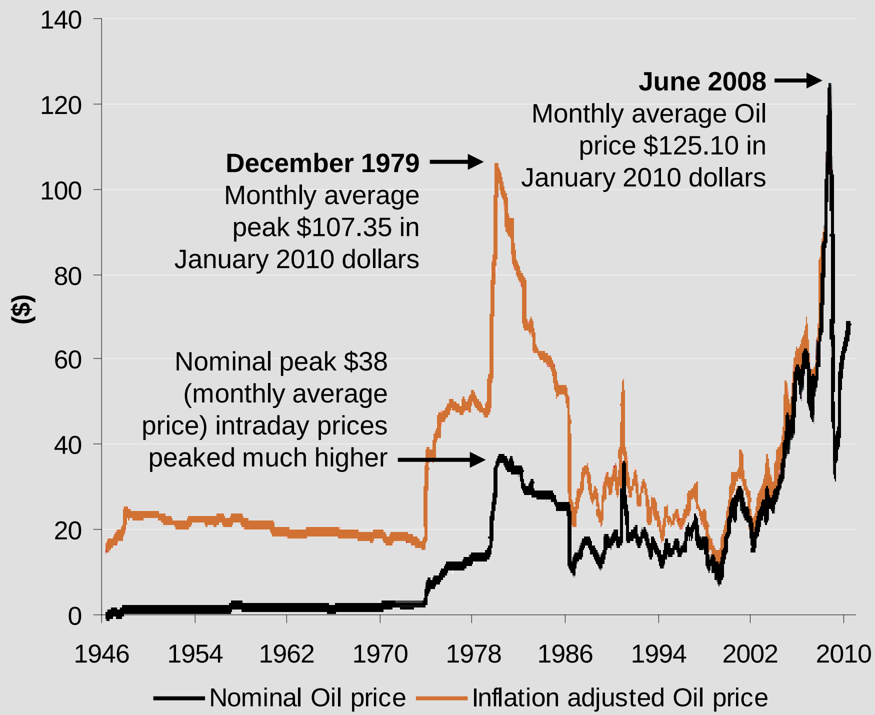
Source: Bloomberg, Ibbotson, UBS

1 For the purpose of this analysis, a normal level of inflation was determined by applying a linear regression model of percentage change in CPI of All Urban Consumers over a 6 month period on the return of one month T-Bills over the same six month period.

Note: Data from July 1959 to December 2004 represents the Equally-Weighted Collateralized Futures Index (as calculated by Gary Gorton and K. Geert Rouwenhorst, February 2005, and described in their paper, Yale ICF Working Paper No.04-20, Facts and Fantasies about Commodity Futures). From January 2005 through June of 2009, this index was constructed by UBS using the same approach as described in this paper and the same basket of commodities as held at the end of December 2004. From July 1959 to December 2008, Stocks are represented by the Ibbotson Large Company Stocks and Bonds are represented by the Ibbotson Long-Term Corporate Bonds Indices. From January 2009 to June 2009, Stocks are represented by the S&P 500 and Bonds are represented by the Citigroup BIG Long Term 10+ Years Index. The risk premium is the average return of an asset in excess of U.S. T-Bills. Historical results should not and cannot be viewed as an indicator of future performance. Source: UBS AG, Bloomberg, Ibbotson Associates; Yale ICF Working Paper No.04-20, Facts and Fantasies about Commodity Futures, Gary Gorton, K. Geert Rouwenhorst, February 2005

Commodities are a store of value against currency debasement

Inflation adjusted – monthly crude oil prices (1946–2010)



Source: www.inflationdata.com. Chart in January 2010 in $

S&P 500 in terms of Gold has lost > 80% of its value (2000–2010)

Source: Bloomberg as at 11 November 2011

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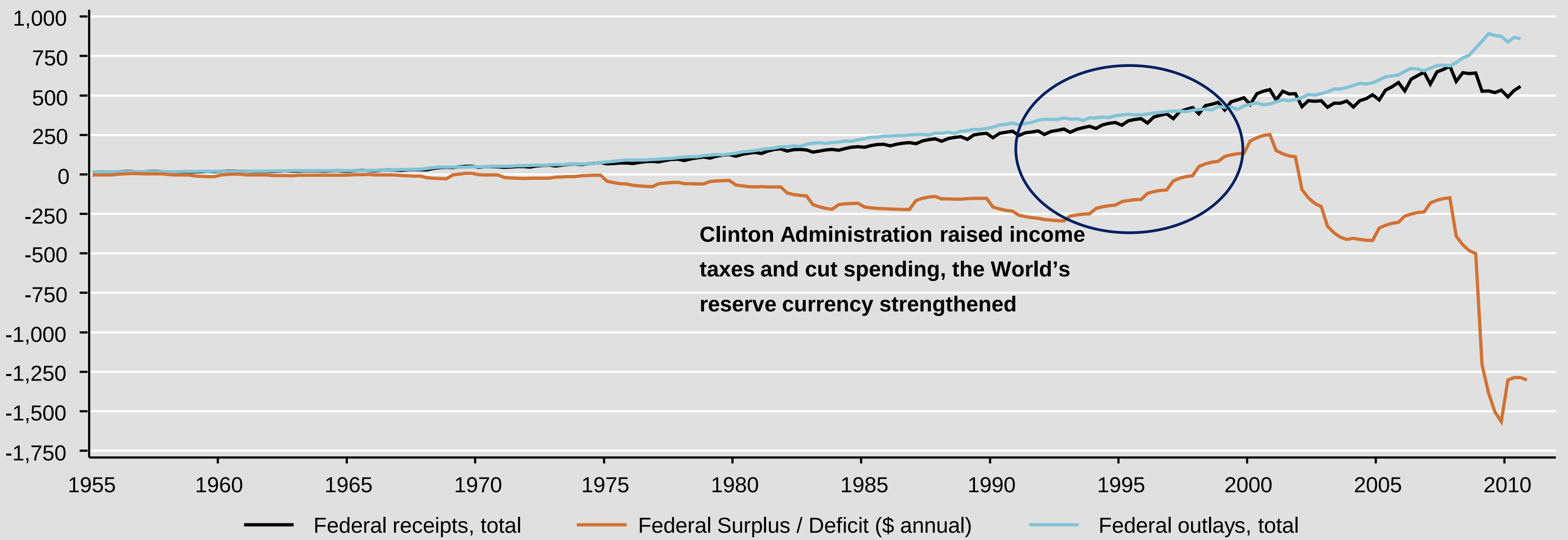
Commodities are denominated in US Dollars

Macro case for weakening currencies is bullish for commodity prices over the long term



Source: Reuters Ecowin

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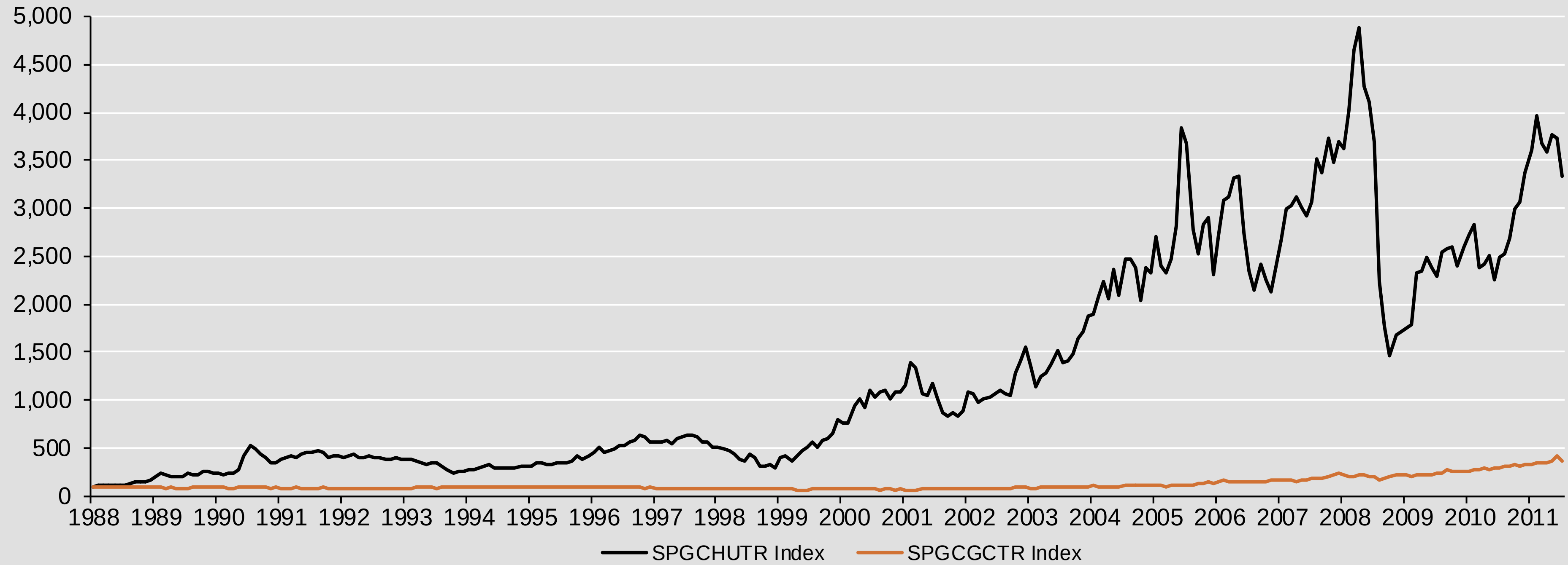
Gold vs. gasoline – is gold really your inflation hedge?

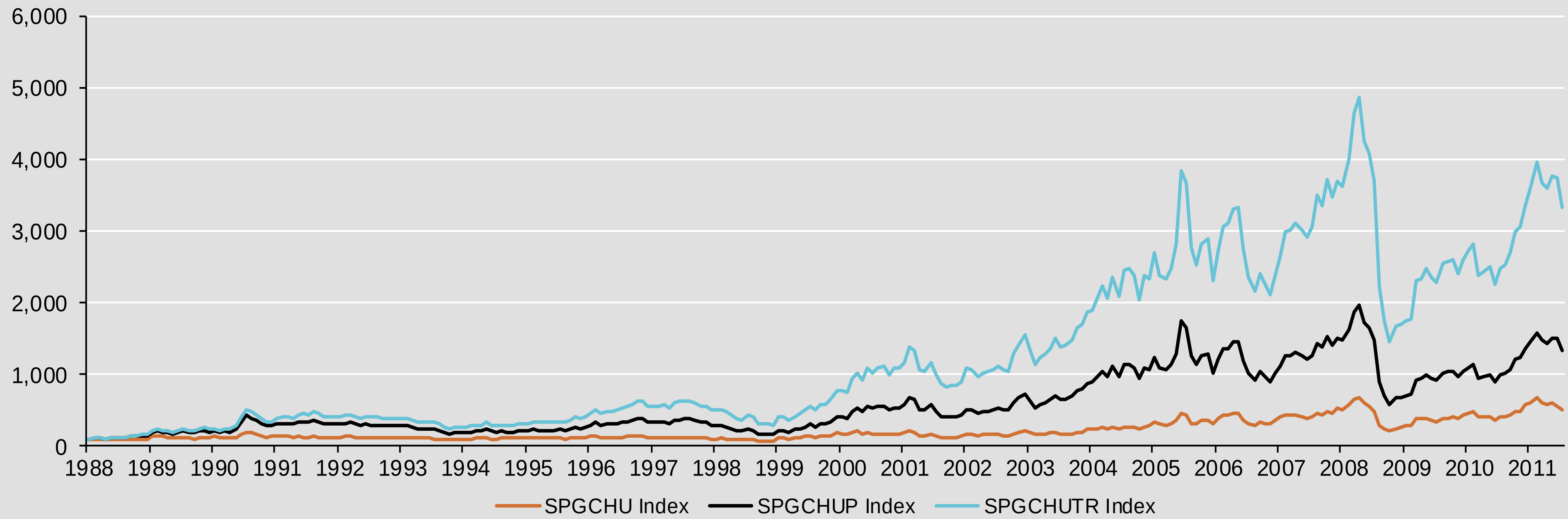
- In spite of recent precious bull market, gold continues to underperform gasoline over the long-term



Source: Threadneedle as at 30 September 2011

Long term gasoline returns: structural positive roll yield

- The long-term strong gasoline performance is driven by term structure
- SPGCHU, the spot return is improved by adding the roll yield, and even more by including the compound interest to create the Total Return



Note: SPGCHU, SPGCHUP, and SPGCHUTR represents the S&P GSCI Gasoline's Spot Index, Excess Return Index, Total Return Index respectively.
Source: Threadneedle as at 30 September 2011

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Commodity market overview

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Market outlook

Fundamentals good, Macro mixed

- **Fundamentals**
  - Inventory levels across sectors are at low levels throughout supply chain
  - Supply response – limits to near term production increases
  - Cost of supply response is escalating – Mine building cost is 5 x 2002 levels
  - Geopolitical risk puts oil supply at risk and increases costs
- **Macro**
  - China and EM are now easing and reducing the risk of a hard landing
  - Uncertainty around European sovereign debt crisis
  - US recovery appears to be gaining momentum

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Market outlook for individual commodities

- Positive on commodities in general, oil based energy is our favourite sector – geopolitics
- Prefer Gold within precious metals supported by Central Banks, low interest rates and QE
- Underweight base metals – most affected by macro-economic headwinds
- Natural gas to continue to underperform due to pressure of shale gas production/weather
- Global inventories of grains and oilseeds remain low increasing the importance of weather
- Demand for high quality protein from emerging markets, especially Asia is rising rapidly

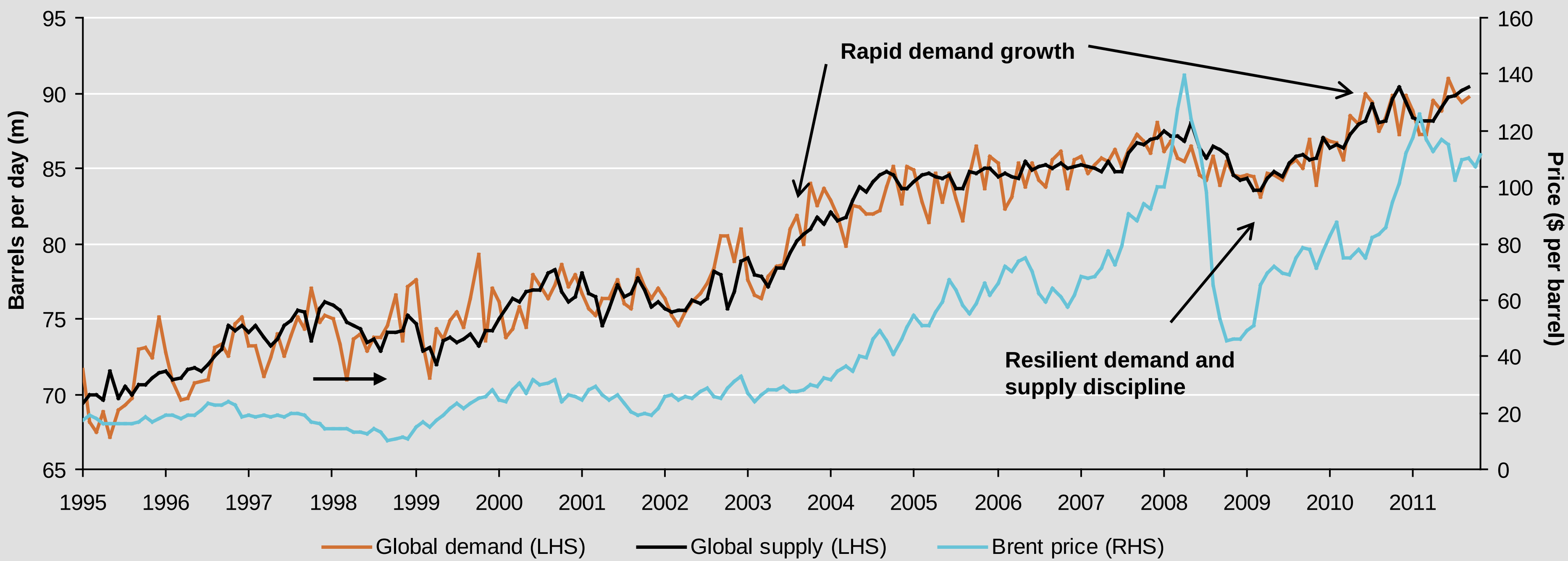
Commodity specific risk

- Last 12 months have been filled with fundamental events and dynamics that affected commodity supply and demand and therefore prices
  - Geopolitics: Middle-East and North African oil producing countries
  - Weather: Drought in US & South America, unseasonably warm US winter
  - Acts of Nature: Earthquake in Japan, Floods in Australia

  - Commodity price risk is skewed to the upside, equity price risk is skewed to the downisde

Crude oil – the $10 billion per day Commodity market

Global oil market – supply disruptions are testing the elasticity of demand



Source: Bloomberg as at 20 January 2012

Energy and the return of geopolitical risk

- Libyan production has been recovering faster than anticipated…

OPEC crude production (million barrels per day)

	Supply			Sustainable production capacitiy[1]	Spare capacity vs. December 2011 supply	2011 Annual Average	Volume Change 2011 vs 2010
	Oct 2011	Nov 2011	Dec 2011				
Algeria	1.29	1.29	1.29	1.30	0.01	1.28	0.02
Angola	1.72	1.69	1.75	1.90	0.15	1.64	-0.09
Ecuador	0.50	0.50	0.48	0.51	0.03	0.50	0.03
Iran	3.53	3.55	3.45	3.51	0.06	3.58	-0.13
Kuwait[2]	2.65	2.67	2.62	2.84	0.22	2.50	0.21
Libya	0.35	0.55	0.80	0.75	-0.05	0.46	-1.09
Nigeria[3]	2.02	2.10	2.06	2.48	0.42	2.18	0.10
Qatar	0.81	0.82	0.82	0.90	0.08	0.80	0.02
Saudi Arabia[2]	9.45	9.75	9.85	12.00	2.15	9.34	0.95
UAE	2.51	2.52	2.58	2.74	0.16	2.50	0.19
Venezuela[4]	2.55	2.53	2.50	2.55	0.05	2.52	-0.01
OPEC-11	**27.38**	**27.97**	**28.20**	**31.47**	**3.27**	**27.30**	**0.20**
Iraq	2.69	2.68	2.69	3.21	0.53	2.67	0.31
Total OPEC	**30.07**	**30.64**	**30.89**	**34.68**	**3.80**	**29.98**	**0.51**
Excluding Iraq, Nigeria and Venezuela					*2.85*		

Source: International Energy Agency as at 18 January 2012
1 Capacity levels can be reached within 30 days and sustained for 90 days
2 Includes half of Neutral Zone production
3 Nigeria's current capacity estimate excludes some 200kb/d of shut-in capacity
4 Includes upgraded Orinoco extra-heavy oil assumed at 470kb/d in September

Energy and the return of geopolitical risk

- … demand continues to strengthen, driven by Asia / Pacific

Global oil demand – 2010–2012 (million barrels per day)

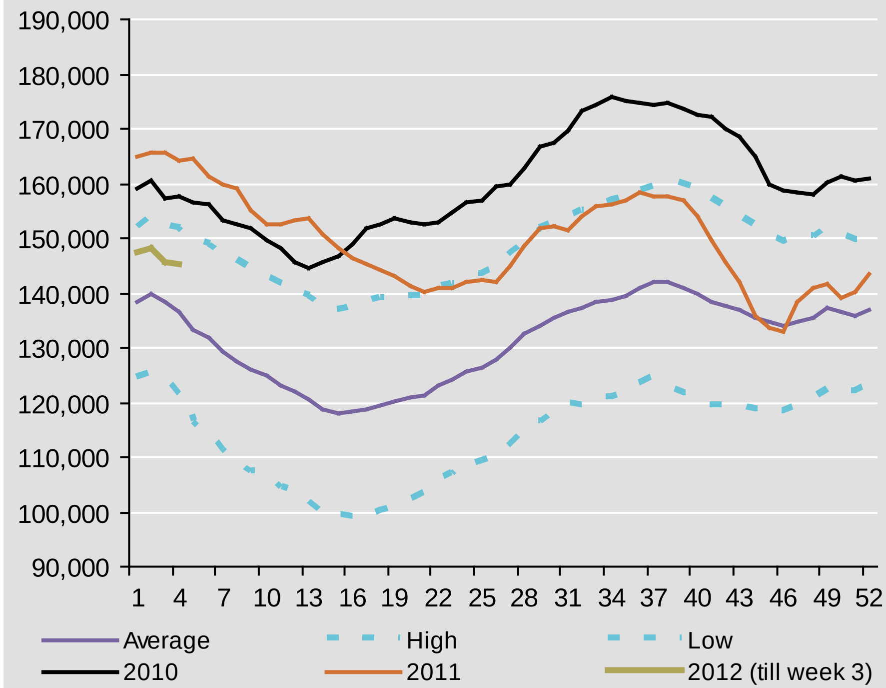
	2010					2011					2012				
	Q1	Q2	Q3	Q4	Total	Q1	Q2	Q3	Q4	Total	Q1	Q2	Q3	Q4	Total
Africa	3.3	3.4	3.4	3.4	**3.4**	3.4	3.3	3.3	3.4	**3.3**	3.4	3.5	3.5	3.6	**3.5**
Americas	29.5	30.0	30.5	30.2	**30.1**	30.0	29.8	30.2	29.6	**29.9**	29.8	29.7	30.3	30.0	**30.0**
Asia / Pacific	27.2	26.9	26.7	28.3	**27.3**	28.6	27.3	27.4	28.7	**28.0**	29.2	28.3	28.1	29.5	**28.8**
Europe	15.0	14.9	15.6	15.5	**15.3**	14.9	14.8	15.4	15.0	**15.0**	14.5	14.5	15.2	15.0	**14.8**
FSU	4.4	4.3	4.6	4.6	**4.5**	4.5	4.6	4.8	4.9	**4.7**	4.6	4.6	4.8	4.9	**4.7**
Middle East	7.4	7.8	8.3	7.7	**7.8**	7.6	8.0	8.5	7.9	**8.0**	7.9	8.3	8.7	8.1	**8.3**
World	**86.8**	**87.4**	**89.0**	**89.7**	**88.2**	**89.0**	**87.9**	**89.5**	**89.5**	**89.0**	**89.5**	**89.0**	**90.7**	**91.1**	**90.0**
Annual change (%)	2.6	3.2	3.4	3.4	**32.**	2.5	0.5	-0.3	0.8	**0.8**	0.6	1.2	1.3	1.7	**1.2**
Annual change (mb/d)	2.2	2.7	2.9	3.0	**2.7**	2.2	0.4	-0.3	0.7	**1.0**	0.5	1.1	1.2	1.5	**1.1**
Changes from last OMR (mb/d)	0.01	0.00	0.01	0.00	**0.00**	0.02	0.05	0.11	-0.31	**-0.03**	-0.51	-0.26	-0.06	-0.06	**-0.22**

Source: International Energy Agency as at 12 October 2011

Overweight oil products remains our conviction trade: distillates are tight….

- Despite mild temperatures, US distillates inventories have tightened significantly
- Demand has been driven by Emerging Market growth
- EM demand for distillates: Jet/Kerosene (+8.3%) and Gasoil/Diesel (+4.1%)

US Distillates inventories

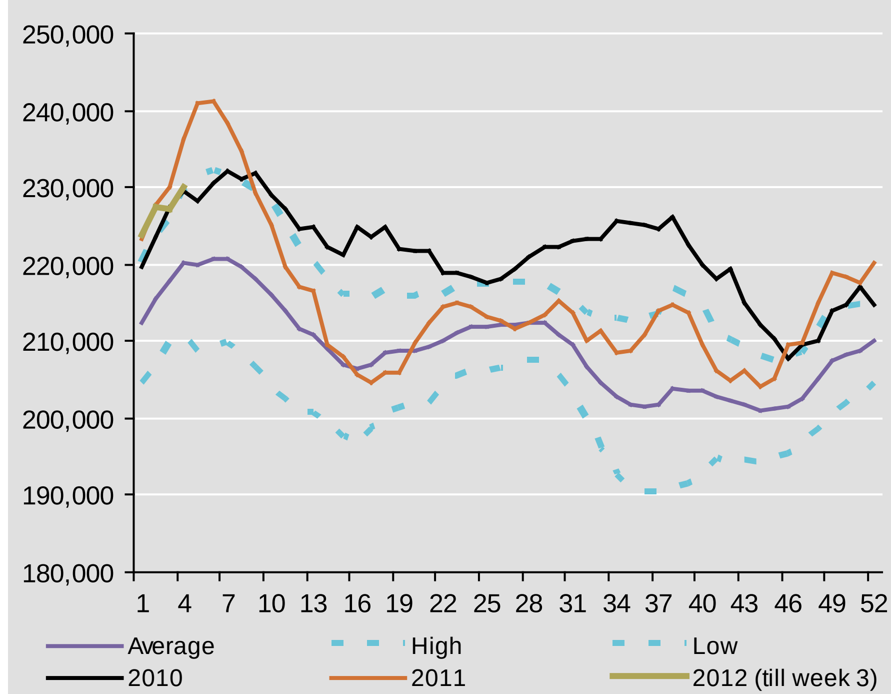


Source: EIA/Threadneedle

… and US Gasoline will get tighter as we prepare for the driving season

- US motor gasoline inventories are tighter inventories
- Several closures of refineries in the East Coast will make the US North East market much tighter this summer
- After Petroplus's bankruptcy, European exports look likely to close the gap

US Motor Gasoline inventories

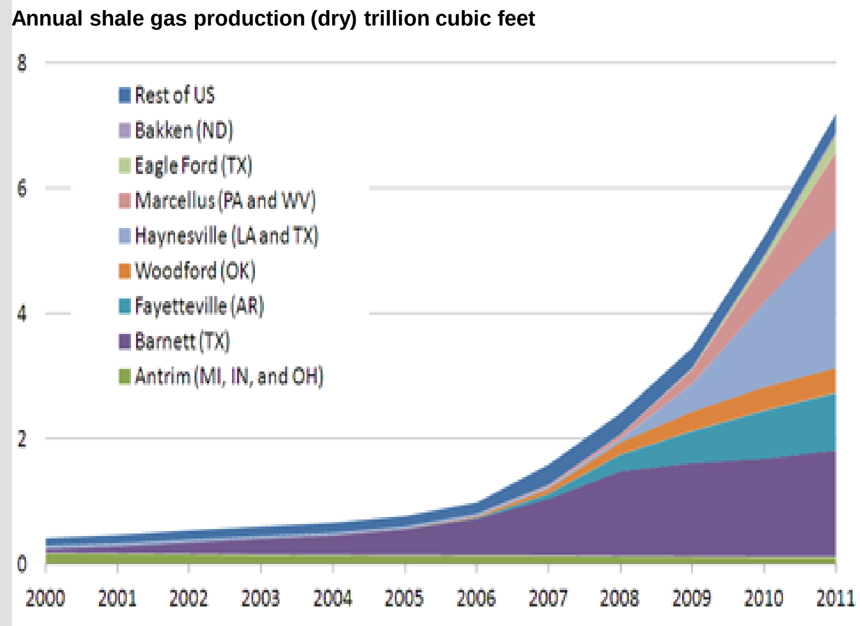


Source: EIA/Threadneedle

Underweight US Natural Gas: it's about shale gas, still….

- Shale gas expansion continues to be the driving force behind US natural gas weakness
- The domestic nature of the US market and the difference in pricing mechanism with international LNG markets is the key to understand the current price dislocation
- The situation is likely to endure until US producers curtail production and/or export facilities come online

Since 2000, U.S shale gas production has increased 17-fold and now comprises about 30% of total U.S. dry gas production



Source: Lippman Consulting, Inc. gross withdrawal estimates as of November 2011 and converted to dry production estimates with EIA-calculated average gross-to-dry shrinkage factors by state and/or shale play. Note: 2011 is annual for first 10 months.

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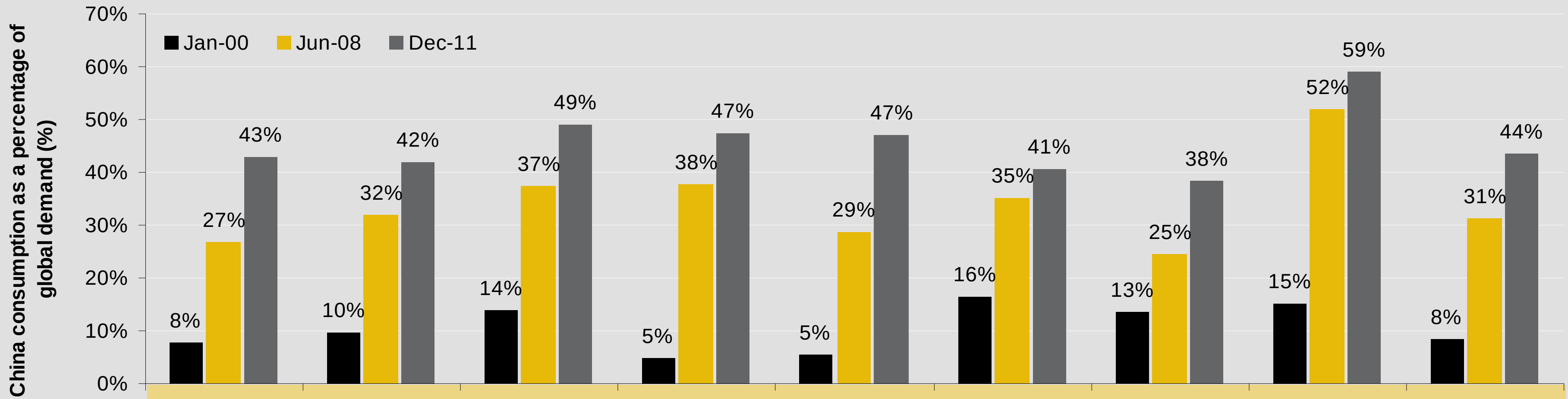
China's Appetite for Raw Materials Continues Unabated

Year on year changes in China's metals' demand as a % of global demand



	Copper	Aluminium	Zinc	Lead	Nickel	Carbon Steel	Stainless Steel	Iron Ore	All Metals (1)
Dec-31-1999 Price	$1,889/t	$1,650/t	$1,235/t	$496/t	$8,475/t	$298/t	$1,599/t	$42/t	90
Jun-30-2008 Price	$8,510/t	$3,114/t	$1,932/t	$1,790/t	$21,950/t	$1,108/t	$4,906/t	$142/t	252
Dec-30-2011 Price	$7,600/t	$2,020/t	$1,845/t	$2,035/t	$18,710/t	$673/t	$3,293/t	$139/t	207
Current price as a % of 2008 prices	89%	65%	95%	114%	85%	61%	67%	98%	82%

Source: Macquarie Research, Ecowin, November 2011

(1) Bloomberg 3 Month Forward Global Base Metals Index

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03

Strategy

A strategy designed to succeed in a radically changing commodity environment

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Portfolio construction: emphasis on relative value

- Focus on **relative value** opportunities within the commodity universe
  - Intra sector
  - Across sectors
- Position size to reflect both **conviction** and underlying market **liquidity**
- Portfolio positions constructed with emphasis on:
  - Correlation
  - Volatility
- **Maximise** performance outcome within the tracking error budget **constraint**
- Deliver **high risk adjusted relative returns** with a portfolio volatility close benchmark

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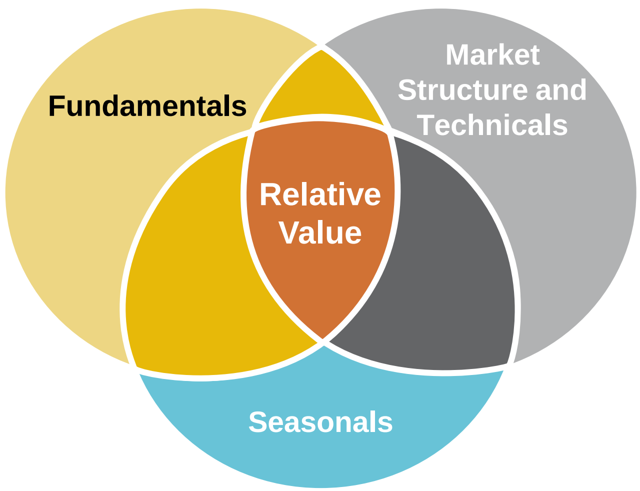
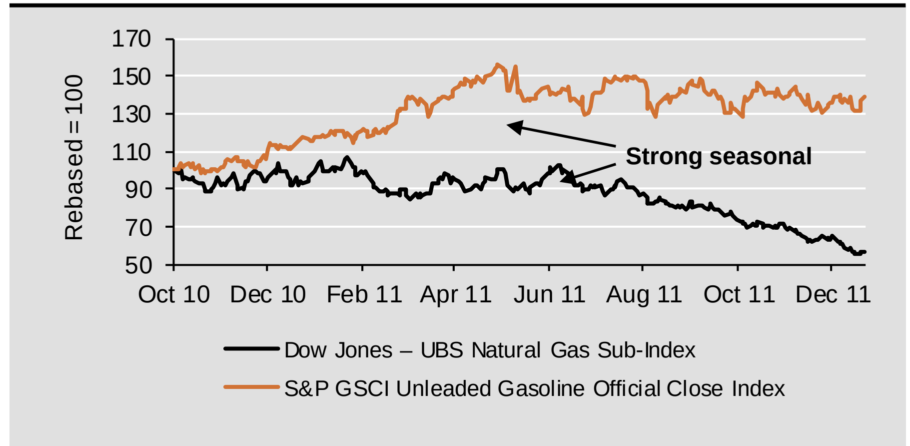
NY Harbour Gasoline v. Henry Hub Natural Gas

- Natural Gas storage constraint
- Robust supply +16,800 wells in ‘11
- Little infrastructure to export
- NGL’s & wet gas increase margins
- Gasoline tight with Middle East supply disruption
- Logistics impaired / affects refining
- US refiners reducing EC capacity

- NG producers actively hedge affecting front of curve
- US NG is a domestic market
- RBOB inclined to backwardation

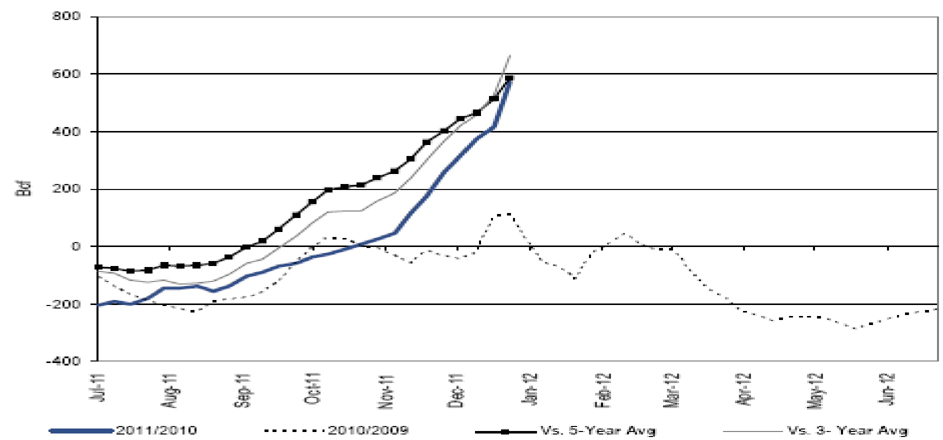


- NG seasonals negative through summer
- RBOB seasonal most positive ahead of US summer and winter changeover



Source: Bloomberg , December 2011

Lower 48 Inventory surplus (deficit) to other years

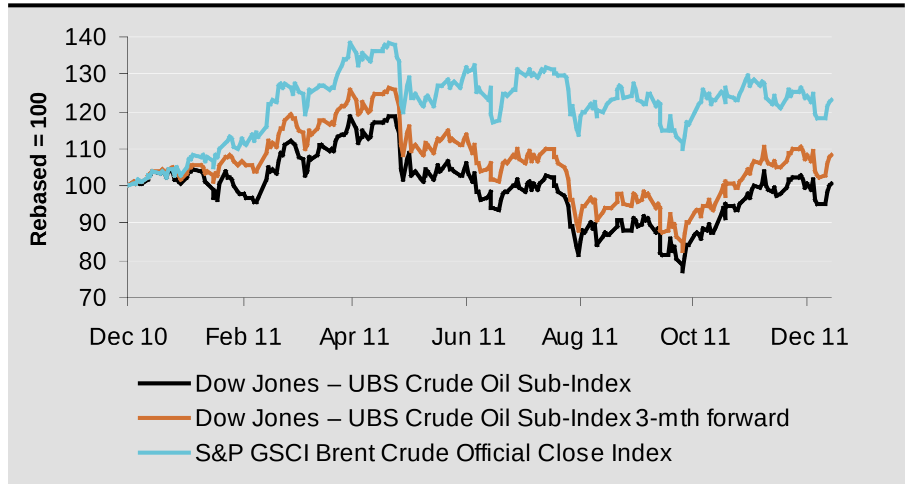


Source: EIA, Citi Investment Research and Analysis

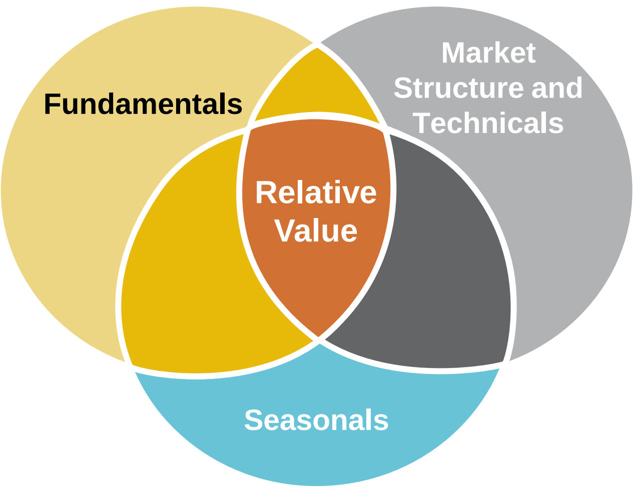
Curve trading and relative value in Crude Oil grades and term structure

- Early 2011 tightness in Brent exacerbated by Middle East unrest
- WTI price and structure both weak due to strong domestic production and storage constraints at Cushing
- Allocated to Brent v WTI in Feb '11
- Front of curve for Brent only
- DJ added Brent in Jan 2012

- WTI price was beginning to fail as a global benchmark and Brent would more accurately reflect the market
- Brent structure would stay strong with loss of Libyan oil
- WTI structure would struggle with limited shipping to Gulf Coast

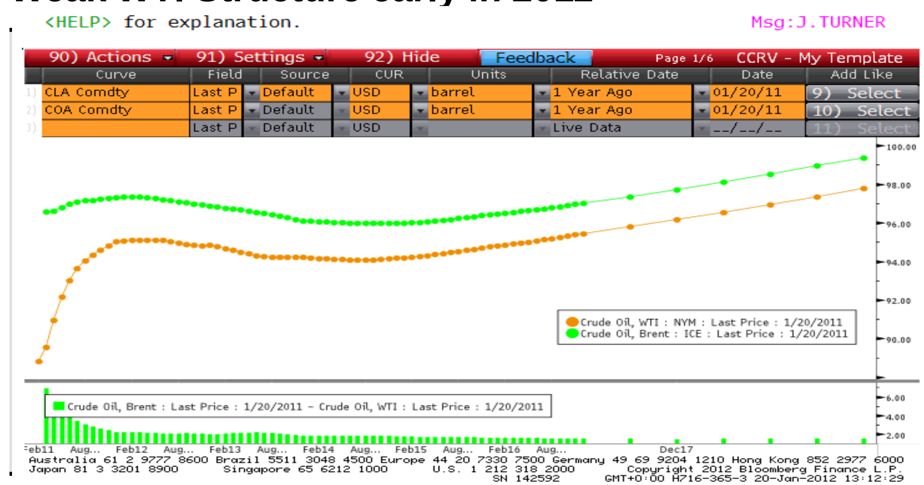


Source: Bloomberg , December 2011



- Seasonal weakness in WTI term structure due to refining maintenance in the first quarter

Weak WTI Structure early in 2011



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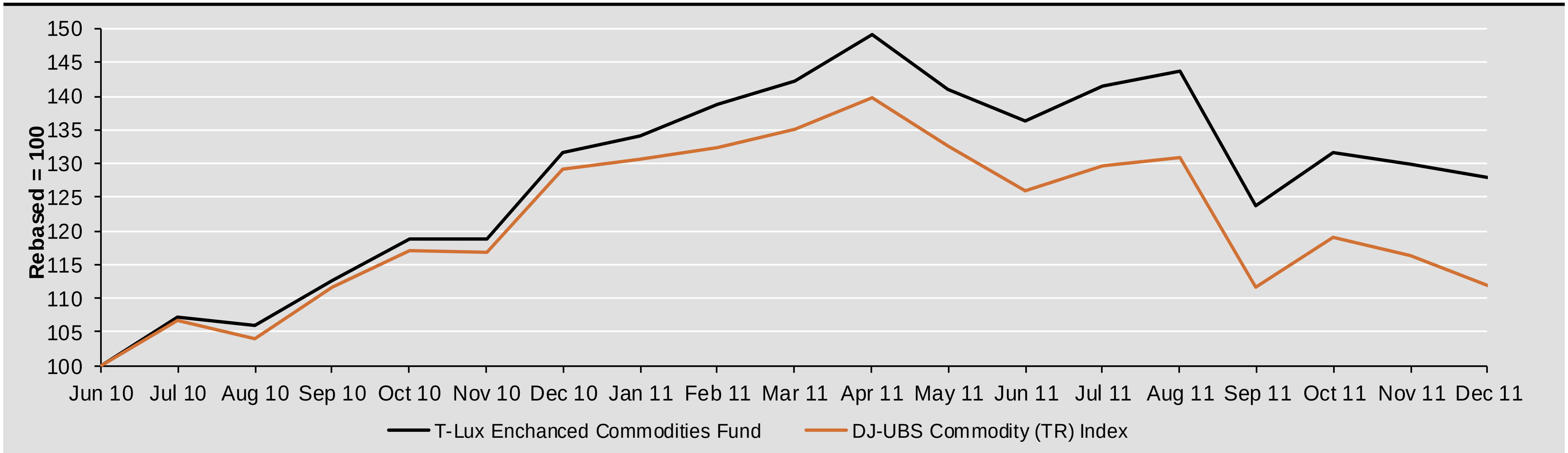
Our Strategy has led to significant out-performance

Threadneedle (Lux) Enhanced Commodities Fund
Performance to Date (in USD)

Performance vs. index



	2011	Since inception[1] (annualised)	Since inception[1] (cumulative)	Historical Simulation Volatility / TE[4]
Fund (gross)	-2.8%	17.8%	27.9%	19.6%
Index[2]	-13.3%	7.9%	12.0%	20.5%
Relative	+12.2%	+9.2%	+14.2%	2.9%
Quartile Ranking[3]	1	1	1	

Source: FactSet as at 31 December 2011. Gross performance based on official global close prices, Fund data is quoted on a bid to bid basis with gross income re-invested at bid. Fund returns calculated Gross of TER (and Tax) for comparison with index
1 Since inception at 30 June 2010
2 Index – Dow Jones-UBS Commodity Index
3 Quartile Ranking of the Fund's net of fees performance, referenced to the Morningstar Peer Group.
4 Factset as at 31 December 2011

Biography

DAVID DONORA
Fund Manager

David Donora joined Threadneedle in 2008 as a Fund Manager specialising in Commodities. His principal responsibilities are to establish Threadneedle's capabilities in this asset class and to develop a suitable product range to complement the company's equity, bond and property offerings.

David has more than 25 years' investing experience encompassing commodity and derivative-based roles. He began his career at Marine Midland Bank in New York in 1982 where he held positions of VP – Commodity Finance, focusing on base and precious metals, latterly trading FX options, and finally Head of FX Options for London and New York. David then moved to UBS NY in 1988 to head its FX and Precious Metals OTC derivatives desk, before transferring to London to take a lead role in developing UBS London's OTC derivative businesses in precious metals, subsequently moving to the dealing side, trading FX and European government bonds.

In 1994 David joined CIBC to establish the London leg of a global volatility proprietary trading business, and became Managing Director and Global Head of FX Derivatives in 1998. In 1999 he created a successful commodity-based proprietary trading and derivative structuring business while Head of OTC Derivatives at Refco Overseas. The business was innovative in that it created unique derivative OTCs in all major asset classes, incorporating 1st and 2nd generation exotics as the building blocks, and managed its risk as a Global-macro Proprietary Trader. Since 2003 the primary focus was in the agriculture and soft commodity markets.

David graduated from the University of Notre Dame with a BA in Finance.

Threadneedle start date: 2008
Industry start date: 1982

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Important Information – Hong Kong

- The Portfolio invests in commodity indices comprised of futures contracts on physical commodities in certain sectors. As these futures contracts approach expiration, they are replaced by contracts that have a later expiration. Depending on the prevailing prices in the underlying market, this could positively or negatively impact the portfolio. Commodity prices may change unpredictably, affecting the index and the level of the index and the value of the Portfolio in unforeseeable ways. The portfolio invests in single commodity indexes which may be particularly susceptible to fluctuation and may fluctuate rapidly based on numerous factors. The commodities underlying the Index components may be produced in a limited number of countries and may be controlled by a small number of producers, political, economic and supply related events in such countries could have a disproportionate impact on the prices of such commodities and the value of the index.
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