Diversification benefits of commodities: A stochastic dominance efficiency approach*

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20 June 2017

Abstract

We revisit the question whether commodities should be included in investors' portfolios. We employ for the first time a stochastic dominance efficiency (SDE) approach to construct optimal portfolios with and without commodities and we evaluate their comparative performance. SDE circumvents the necessity to posit a specific utility function to describe investor's preferences and it does not impose distributional assumptions on asset returns. We find that commodities provide diversification benefits both in- and out-of-sample. This evidence is stronger when commodity indices which mimic dynamic commodity trading strategies are used. We explain our results by documenting that commodity markets are segmented from the equity and bond markets.

JEL classification: C1, C4, C6, G10, G11

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* We are grateful to two anonymous referees for their stimulating, thorough and constructive comments. We would also like to thank Ines Chaieb, George Constantinides, Jens Jackwerth, Olga Kolokolova, Alexandros Kostakis, Kalle Rinne, Raman Uppal and participants at the 2015 International Conference on Computational and Financial Econometrics (London), 2016 Spring Conference of the Multinational Finance Society (Lemesos), Alternative Investments Conference (Monaco), 2016 Energy and Commodity Finance Conference (Paris), 2016 CRETE (Tinos) conference and the University of Crete seminar series for useful discussions and comments. Financial support from the from the Research Centre of the University of Piraeus and the J.P. Morgan Center for Commodities at the University of Colorado Denver via the Commodities Research Fellowship Grant award is gratefully acknowledged. Any remaining errors are our responsibility alone.

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