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Diversification benefits of commodities: A stochastic dominance efficiency approach*

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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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