



## THOUGHTS ON LONG-ONLY COMMODITY INVESTING – APRIL 2005

The argument for portfolio diversification via investment in the commodity markets is well documented, and has been lent further credence in recent years by the relatively poor performance of equity markets, and publication of fresh research by various institutions;

**"In addition to offering high returns, the historical risk of an investment in commodity futures has been relatively low...A diversified investment in commodity futures has slightly lower risk than stocks.....Commodity futures returns have been especially effective in providing diversification of both stock and bond portfolios".**

*"Facts and Fantasies about Commodity Futures", June 2004  
Gary Gorton, The Wharton School, University of Pennsylvania, K. Geert Rouwenhorst, Yale University*

This renewed "legitimacy" of commodities as a valid asset class, coupled with poor returns from equity and bond markets, has prompted significant inflows into global commodity markets in recent months (and has also prompted the staging of a veritable glut of commodity conferences). Phrases such as "super-cycle" and "super-spike" have entered the lexicon of commodity language, but is such hyperbole warranted? Cynics might suggest that some of those propagating some of the more hawkish stories have a vested interest in higher prices – bulls include Goldman Sachs (developer of the GSCI=Goldman Sachs Commodity Index), AIG (developer of the DJ-AIG CI=Dow Jones-AIG Commodity Index), and Jim Rogers (developer of the RIC=International Commodity Index).

But cynical or not, these investable indices have attracted significant investment – Barclays Capital estimate that holdings in these indices have grown from \$2billion in 2002 to over \$45billion currently. Barclays also estimate that investments in commodity-linked mutual funds have similarly surged from around \$200million in 2003 to over \$8billion currently. Our own research indicates that index holdings are most likely higher than this. Figure.1 below shows cumulative open interest figures for the commodities shown. Clearly it can be seen that not only does open interest rise steadily over time, but that the last 18 months or so have seen a sharply higher rate of change:-

### Contracts included:

#### LME

- Copper
- Aluminium
- Zinc

#### COMEX

- Gold
- Silver
- Copper

#### NYMEX

- WTI
- Natural Gas

#### NYBOT

- Cocoa
- Coffee
- Sugar

#### CBOT

- Corn
- Wheat
- Soybeans

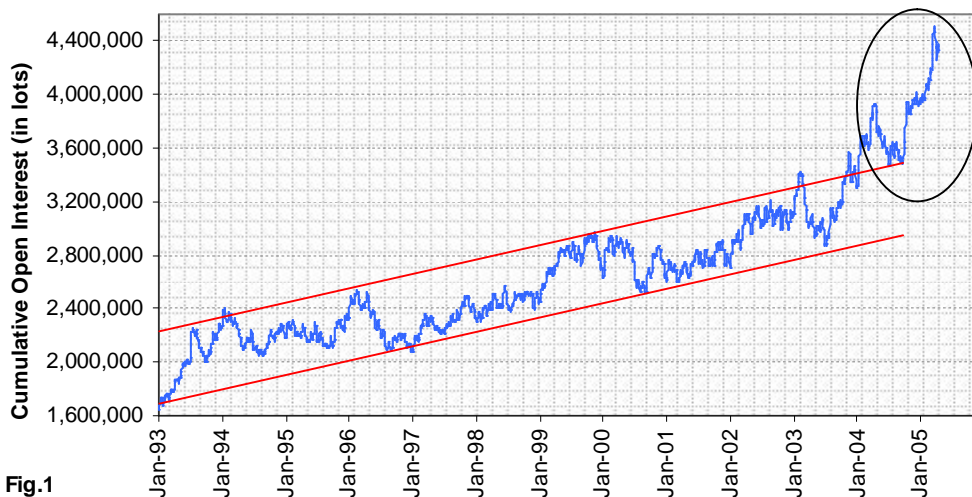
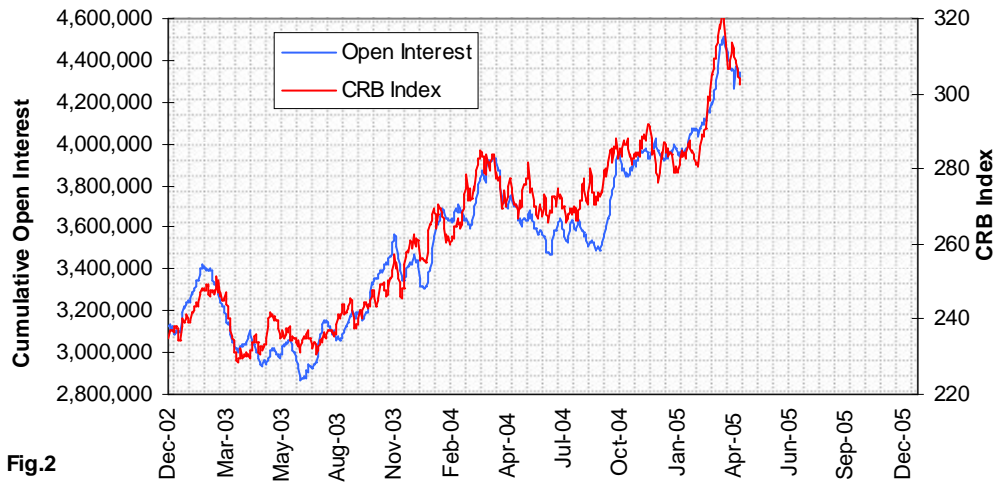


Fig.1

If we consider that the market is "over long" by approximately 800,000 contracts, then we can translate that into a gross portfolio exposure of approximately **\$40billion** (we calculate this portfolio exposure via implied margin requirements). And this is just investment into the above 14 commodities, and only includes on-exchange futures. It does not include other metals or energy products. Or any of the power, electricity, weather, meat and fibre sectors. Or other global exchanges (LIFFE, TOCOM, SHENZEN etc). Or options. Or any physical holdings, or OTC products. Or commodity related equities.



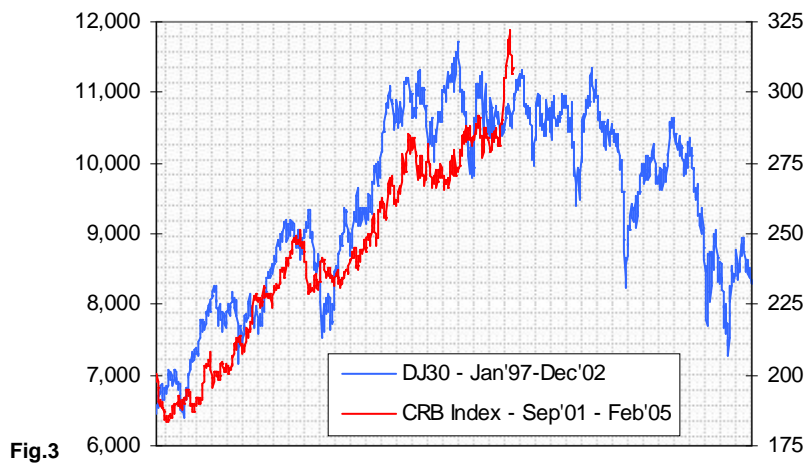
Clearly therefore global exposure to commodity prices is already high. Fig.2 shows the clear high correlation between rising open interest and the Commodity Research Bureau Futures Index (CRB). Given this high correlation (running at +0.97), and the fact that the CRB index has risen 28% while open interest has risen 38%, I think it is fair to say that this increase in open interest has been fresh longs.

Whenever we see figures like this, one question always springs to mind; What on earth is the exit strategy?

**We know the market has significant commodity exposure, but long only?**

While the investment community have minutely analysed equity and financial markets and performance, it seems to us that they have not applied the same due process to the commodity markets. Consequently, when assessing equity market investments, the investor has a veritable gamut of options – long/short, event-driven, relative value, index tracking, convertible arbitrage etc. The list goes on. Conversely, and although some commodity investments are given to active (discretionary or systematic) managers, the vast majority of investment in the commodity sector gets allocated to long-only strategies. Of course there are certain regulatory restrictions on certain investors, and in any case these indices are useful tools – they clearly provide access to the beta afforded by commodity markets. But we would argue that this passive-only approach to commodity investment is riddled with risk on a stand alone basis.

Passive, long-only investing, by definition, only gives positive capital returns when markets are going up. While long-only is the oldest form of investing, the trend accelerated dramatically in the late 1990's as equities rallied sharply. Markets consequently saw a dramatic proliferation of new index-tracking products that promised to replicate equity market indices – with their substantially lower fees, they were hailed as the future of equity investment. As shown in Fig.3 (below) however, they soon lost their attraction when equity markets turned and spent the next three years heading lower. It is curious to see the close correlation between the DJ30 over this period, and the current CRB Index – the correlation coefficient is a healthy, if worrying 0.93.



Of course there is another potential return stream available to investors in these instruments: total return...

While the owners of said indices would argue that total return is the place to be, we would argue that the vast sums of money being allocated to these strategies will ultimately deflate this phenomenon. Total return is the additional value achieved by buying forward into markets that have steep backwardations, and thereafter “rolling up the curve”. It can be likened to the dividend stream from equities, but buying a share for the dividend makes no sense when the company is suddenly unable to pay out. The same logic holds with regard to total return investing. Commodity markets are vulnerable to short-term dislocations, but are medium-long term efficient. When a relatively small group of traders become aware that billions of dollars worth of long positions are to be rolled from March to April for example, the rate achieved for the roll will most likely not be as it may otherwise have been. Even if this were not to happen though, rising prices should lead to increased supply and falling demand and therefore diminishing backwardations. So there is the real possibility that the potential capital gains realised on a long-only investment could undo the total return available.

As an aside, the assessment of market liquidity and slippage issues is a major key to successful commodity investment, and a theme of previous presentations by Jaguar.

## Is long-only the place to be – is this bull market here to stay?

There is a school of thought that says this time it is different. A new paradigm. This school of thought says that the lack of investment in supply infrastructure over the last twenty years cannot possibly cope with the enormous demand coming from China, India and other new emerging “wunderconsumer” countries. Oil reserves are almost depleted. China consumes 50% of the worlds cement and 20% of the worlds copper. The statistics roll on. The global economics team at HSBC summarise their latest quarterly report with the line;

**“The old ways of looking at the global economy are no longer relevant”.**

And maybe this school of thought is right. Maybe we really are in a brave new world.

But I for one am not convinced. And neither it seems are many of the commodity analysts working for banks, trade houses, financial institutions and brokerage groups. Recent metal and crude oil price forecast surveys are outlined in the table below – and two thoughts spring to mind.

2005 FORECASTS	HIGH	LOW	MEAN	RANGE (%)	CLOSE 2004	CHANGE (%)
COPPER	3,086	2,204	2,729	40%	3,280	-17%
ALUMINIUM	2,006	1,499	1,779	34%	1,964	-9%
NICKEL	16,535	10,979	13,027	51%	15,205	-14%
ZINC	1,367	992	1,177	38%	1,270	-7%
LEAD	992	750	842	32%	1,056	-20%
TIN	9,193	6,305	8,062	46%	7,765	+4%
GOLD	463	380	434	22%	438	-1%
SILVER	7.20	5.65	6.56	27%	6.82	-4%
CRUDE	51.75	39.00	45.12	33%	43.45	+4%
				36%	AVERAGE	-7%

Firstly, the range of each forecast is ridiculously wide. The tightest range of forecasts is for the gold price, though at 22% it can hardly constitute a consensus opinion. And it doesn't include potential price spikes – the true range of potential gold forecasts was from 340 to 525, a range of some 54%. So the price could go up 20%, or fall 22%. No real clues there then.

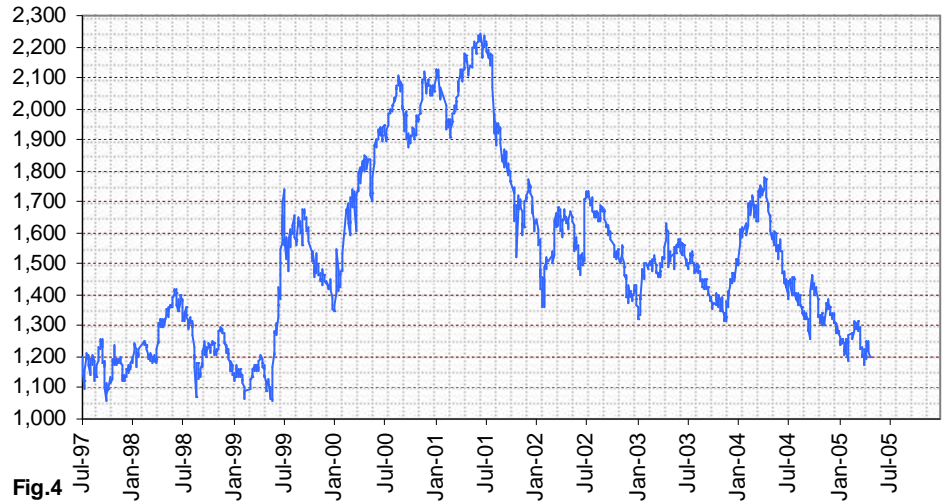
Secondly, with an average price **fall** of 7%, the forecasts could hardly be called positive. And even if one looks at the top end of expectations as coming in correct, it would still only generate an average price rise of some 6% - again, hardly what one might call rampantly bullish.

We would also err on the side of caution with regard to China. Seen by many as having an insatiable appetite for industrial materials, recent reports indicate that the Chinese have over-ordered in many markets, yet continue to add to stockpiles. They have plenty of new waterfront condominiums they can't sell. Government reports continue to dwell on efforts to cool the economy. And the Chinese stock market continues to fall – hitting lows not seen since May 1999. Figure 4 shows the performance of the Shanghai Composite Stock Index over the last 8 years.

# Jaguar Investments Limited

Recent annual performances of the index have been as follows;

2001 = -20.60%  
 2002 = -17.50%  
 2003 = +10.30%  
 2004 = -15.40%  
 1Q'05 = -6.70%



Not what one might term reflective of a buoyant economy. And as reported by the Association for Asian Research;

**“A survey by Xinhua News Agency at the end of last year indicated that in the past three years nearly half of investors lost more than 50 percent of their investment, 75 percent of investors choose “never to invest in the Chinese stock market again.”**

One of the world’s foremost China bulls in recent years has been Jim Rogers – indeed he was most likely the first China bull back in the late 1990’s. In his book Adventure Capitalist, he writes:

**“Whereas the 19<sup>th</sup> century belonged to Great Britain and the 20<sup>th</sup> to the United States, the 21<sup>st</sup> will be the century of China”.**

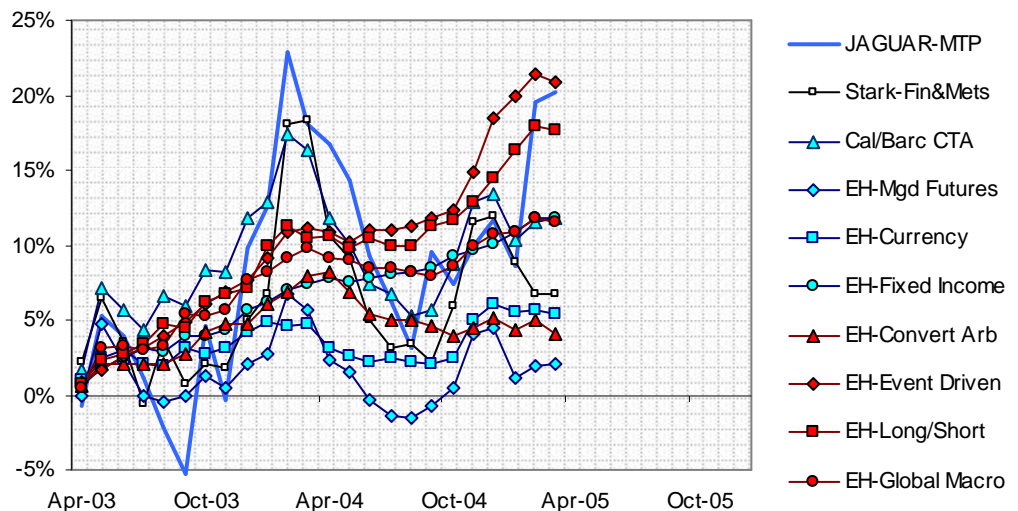
Mr. Rogers goes on to acknowledge that before this can happen the currency needs to float. But in my mind, we are not going to know whether that prophecy is true or not until the second half of the century. And I’m not sure how many longs in the commodity market today have a 50+ year investment horizon. And as positive as Mr. Rogers is on China, he also writes;

**“Certainly China will suffer setbacks along the way, just as the United Kingdom and the United States did in their rise to greatness”.**

## Conclusion

Given what we believe, namely:

1. Commodities remain a valid asset class, but that
  2. The market is extremely long, and
  3. Markets can be illiquid, and
  4. China may suffer short-term weakness, but that ultimately
  5. Nobody knows where prices are going,
- Long-only at current levels may be dangerous.



**We would suggest diversifying long-only commodity investments via an allocation to a focused, specialist, commodity-only manager, whose investment strategy is able to capture both bull and bear markets, whose processes are disciplined, and whose track record is solid.**

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