



WHY COMMODITIES – OCTOBER 2012

HISTORY

Generally there are significant bull markets in commodities every 20-30 years which are caused by long term supply/demand imbalances. Before the current bull market began, natural resources had been in a bear market for about 25 years (gold had peaked at \$850 in 1980, sugar at 65cts in 1974 and oil at \$40 in 1980). Declining prices do little to attract investment in production capacity, and this two-decade long tailing-off of investment in research and development led to existing production falling (as reserves were depleted) and a much shorter pipeline of new production projects. Commodity supply is relatively inelastic. Geological exploration of metals and energy can take years, if not decades to come to fruition and similarly crops can take several years to grow and mature before harvests produce decent yields. Prices troughed in the late 1990's, with gold trading down to \$250 and sugar trading down to 4cts (both in 1999). Oil had traded down to \$10 in 1998.

In the nascent years of the 21st century, however, a perfect storm grew in global commodity markets as China developed a seemingly insatiable appetite for commodities and world population continued to grow. At the same time investors began to seriously consider the commodity sector. Many were wary of equity markets in the wake of the dot-com collapse, the 9-11 attacks and the increase in global terrorism. Others were simply distrustful of paper assets after Enron, WorldCom etc. Some were more fearful of inflation and looking to hedge. In part these investors were looking for yield, but all were looking to diversify equity-bond portfolios.

These developments led a number of academics to review the commodity sector from an investor perspective. Papers and books such as "Facts and Fantasies about Commodity Futures" by Gary Gorton and K.Geert Rouwenhorst, and "The Adventure Capitalist" by Jim Rogers lent a renewed legitimacy to commodity investing.

"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*

TODAY

The portfolio diversification benefits of commodities had been known for a while, but have gained further and significant credence in recent years. Moreover the recent economic climate (low returns from cash, equities, credit/debt markets) has ensured investors look elsewhere for yield and commodities are now regarded as a genuine asset class.

Making commodities more "interesting" is the fact that much of the worlds supply is produced in a number of the worlds more volatile regions. The Middle East remains the key to the oil market. Likewise Brazil and India are mostly responsible for sugar. Ivory Coast for cocoa. Wheat and PGMs in Russia. The changing political landscape (and arguably the world power shift from developed to developing countries) can and will have a key impact on commodities – most importantly on its supply which as we have seen is inelastic. Given that population growth seems unlikely to slow anytime soon, there is a background upside bias to commodity prices for the foreseeable future.

Nevertheless this commodity bull market will not be linear. Short-term price performance is driven more by demand than supply and with current Eurozone stresses and concerns over a Chinese slowdown, commodity price action is vulnerable to bear markets.

"Whereas the 19th century belonged to Great Britain and the 20th to the United States, the 21st will be the century of China..."

Certainly China will suffer setbacks along the way, just as the United Kingdom and the United States did on their way to greatness."

*"Adventure Capitalist", 2003
Jim Rogers*

KEY FEATURES

- Commodities influence a significant portion of the world economy and can be viewed as the largest "non-financial" market in the world.
- Commodity price action can be a key (and leading) indicator of economic well-being, with larger themes being played out over a number of years.
- Commodity price action is not reliant on Western economies – indeed it is driven increasingly by BRIC, MENA and other EM activity.
- Commodity price action is reflective of the changing geo-political landscape, NB "Axis of Evil", Arab Spring, Eurozone stresses.
- Commodities offer real portfolio diversification benefits.
- Commodities are hard assets and offer real, transparent value versus paper assets and fiat currencies.
- Commodity terminal markets are tightly regulated exchanges, with relatively low transaction costs and excellent transparency

PASSIVE OR ACTIVE?

If it is accepted that commodities are in the early stages of a 20-30 year bull market, then surely buy and hold is the answer? There are enough products to choose from – the uptick in commodity prices in the early-mid 2000's led to a proliferation in investable indices and ETFs. However there are two key flaws to long-only investing in commodities;

Bear markets

Although commodity prices are arguably in a cyclical bull market, there have been (and will continue to be) bear market phases. These can be substantial. Chart.1 below shows the performance of the Reuters/Jefferies CRB Index. When investing in these vehicles, timing is critical.

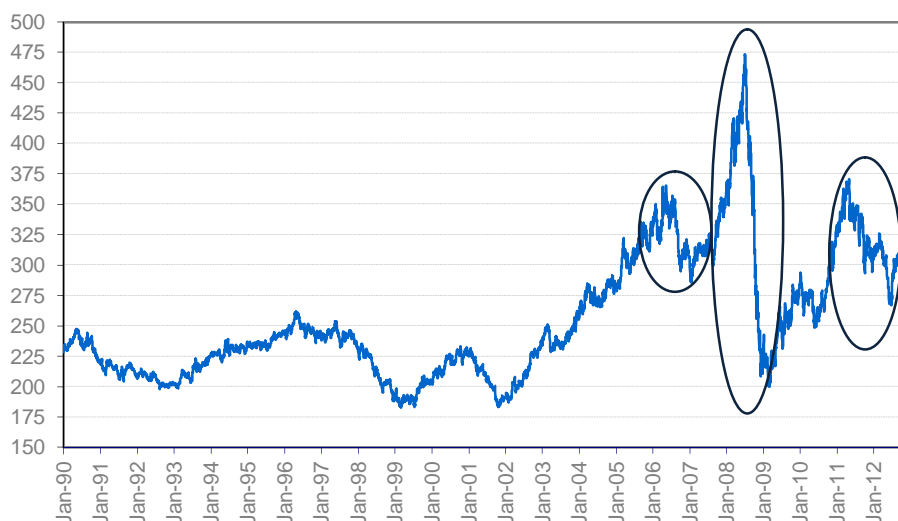


Chart.1 – Reuters/Jefferies CRB Cash Index

Clearly there have been three bear market phases since the start of the bull market in 2002; the first resulted in a drop of 20%, the second in a drop of 58% and the current drawdown is currently some 15%. Indeed values are currently where they were back in March 2005 (over 7 years ago). The S&P500 is up around 19% over the same period.

Contango markets

Contango is the phenomenon in commodity markets whereby forward prices trade at a premium to nearby prices. This premium is reflective of the cost of financing, storing and insuring the commodity. In times of scarce supply, nearby material can trade at a premium to forward prices – a phenomenon known as backwardation. For holders of long-only indices, a backwardation is a bonus that can massively enhance returns. This is because index-linked products are long nearby futures contracts which have to be rolled at maturity. If one can sell the nearby contract at a premium to the simultaneous purchase of a forward futures contract then value is added. If the nearby contract has to be sold at a discount however, then clearly that will result in a cost. The benefit of rolling long futures contracts when in backwardation is critical to the success of a long-only product. Indeed they can be likened to the receipt of dividend payments in a long-only equity portfolio. Without them, the portfolio is reliant on capital gains alone.

Commodity markets are relatively small however and the reality is that the investments in long-only products have grown so large that the volumes of futures contracts needing to be rolled are extraordinary. They are so large, in fact, that for the most part they have eliminated any possibility of backwardation – there is rarely ever likely to be a shortage of nearby material because so many investors are long. This can be seen in Chart.2, below, which shows the contango and backwardation of the NYMEX WTI Crude Oil contract;

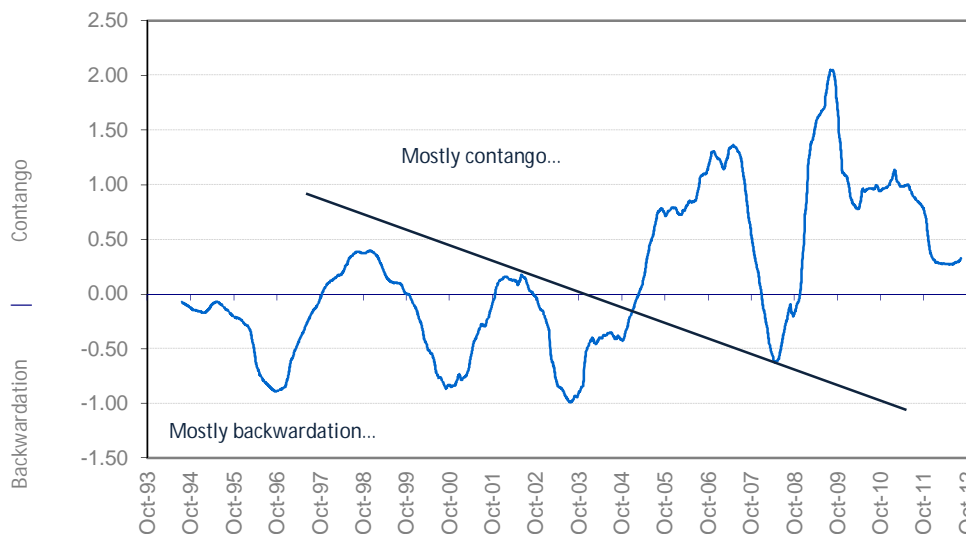


Chart.2 – 1st month vs 2nd month futures contract, NYMEX WTI Crude Oil contract (200day ma)

You can see that for the first ten years, the price was mostly in backwardation. This ran at approximately 24cts/bbl per month. Since that time however, the price has rarely been in backwardation (there was a brief period in early 2008 when the price touched \$150/bbl). The average monthly contango since March 2005 has been 76cts/bbl.

In time, this implied "loss" of \$1/bbl (24cts backwardation to 76cts contango) can be punitive. Chart.3 below shows the relative performance of the flat price of NYMEX WTI Crude Oil and the performance of a portfolio that had to roll futures contracts on a monthly basis.

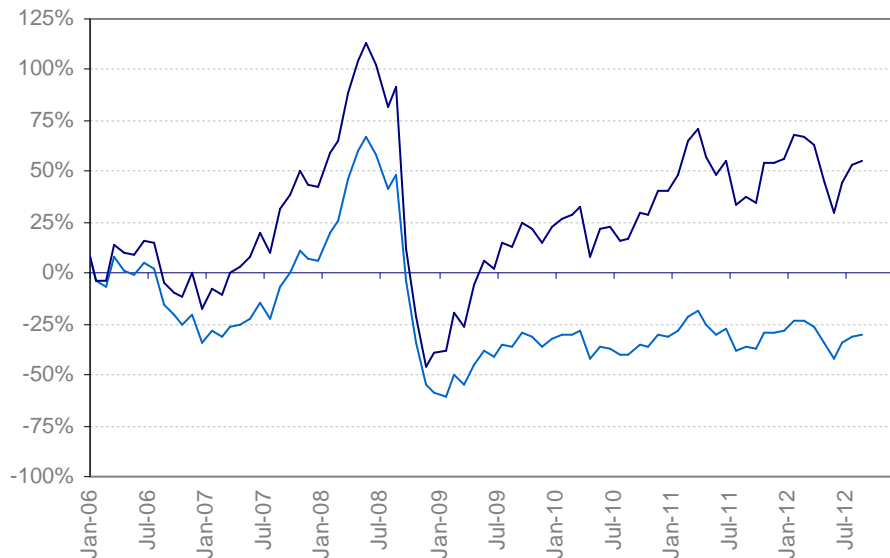


Chart.3 – Flat price performance vs portfolio of front month rolling futures, NYMEX WTI Crude Oil contract

CONCLUSION

- Over time there should be greater demand and less supply – therefore in time there should be higher prices
- But volatility will remain high – gains will not be linear
- Long-only indices are vulnerable to contango
- Long-only indices are vulnerable to bear markets

We believe that active management of a diversified commodity portfolio offers a significantly more attractive risk-adjusted return stream.