September 2005

Crow Anyone?

Luck always follows the prepared mind – Jim Rogers

I admit it. I was wrong. In my April 2000 letter "Coffee Anyone?" (accessible @ www.accessinvestmentadvisors.com), I bad mouthed commodities. Since then I have done quite a bit of reading and research on the role of commodities in reducing risk and enhancing returns in portfolios and have done an about face. Can you forgive me corn?

As I've written in the past, I am concerned about the future returns (or lack thereof) in the stock market. I'm certainly not throwing in the towel, but the easy money has left the table. I recently read a research piece by Ed Easterling of Crestmont Research in Dallas, TX. In it he deconstructs the 10.4% historical rate of return in US stocks. Based on the three factors that drive stock prices – economic growth, dividend yield and price earnings ratios, he concludes (quite convincingly) that the average rate of return in stocks for the foreseeable future will be closer to 6.5%. Now remember, we are striving for returns better than the average, but we will be running uphill.

Enter commodities. While stock prices were on a tear for the past two decades, commodities were relegated to the back of the bus. Many of the world's commodity prices peaked in the late 70's. Oil hit an all time high in 1980 (and no, we're still not close), as well as Gold and Lead. Sugar peaked in 1975 and then spiked again in 1980. Remember those days? I do. It was a time of gas lines, recycling, and sweaters – indoors. The early 80's marshaled in the era of paper assets (stocks and bonds) with low inflation and strong economic growth.

Commodity prices suffered greatly in the past two decades. Peak prices were followed by collapse as demand fell off. The price implosion drove many producers out of business (remember the US steel bailout?). Fast forward to the present. Demand for all commodities has started to pick up, driven in large part by the Chinese. According to the Commodity Research Bureau, China is the number one consumer of copper, steel, iron ore, soybeans and the number two consumer of oil and energy products (we still win this one). We appear to be at an inflection point for many commodities, where two decades of declining production is about to slam headlong into voracious consumption.

All of the above got my attention, but the following hit me over the head. A 2004 study by Gary Gorton of the University of Pennsylvania's Wharton School and K. Geert Rouwenhorst of the Yale School of Management concludes:

- Since 1959 commodities futures have produced better annual returns than stocks and bonds with less risk (as measured by standard deviation – a tool for assessing the variability of returns).

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- Stocks and commodity prices appear to be inversely correlated (a long term study conducted by Legg Mason shows that stock and commodity cycles average about 18 years and have traded off leadership seven times since 1880). This means that when stocks zig, commodities zag – a good thing when building solid portfolios.

- The Returns of commodities futures were positively correlated to inflation (they move in the same direction). Inflation is typically bad news for stocks and bonds.

Here's the clincher. There are somewhere in the neighborhood of 8000 mutual funds in existence today. There are only four that specialize in commodity futures, and two of them are less than a year old. Smells like opportunity to me.

OK, so does this mean we're going to back up the truck and fill it with soybeans? Not exactly. Commodities are traded on exchanges that have been around for well over a century. They trade in "futures" or contracts to deliver a given commodity to the buyer of that contract. These contracts exist for relatively short periods of time and must be "closed out" (sold if you bought the contract, or bought if you sold) before the delivery date (or you will be knee deep in pork bellies). When trading futures you keep closing out and rolling your positions forward to take advantage of either a perceived rise or fall of the particular commodity chosen.

What are the risks? Much like stocks, the prices can rise or fall with prevailing supply and demand. Unlike stocks though, I've never seen a commodity price go to zero.

How much is enough? We are not talking about a major change in asset allocation, but more of a subtle shift in the equity portion of portfolios to hedge risk.

Our challenge is to find the appropriate investment vehicle. Up until recently, unless you had a seat on the Chicago Board of Trade or similar exchange, there was little access to these markets. This is changing as some credible players are developing products. We are looking for a commodity based investment that will give you representation to a broad basket of commodities rather than trying to speculate on which one will be the next big winner.

In a couple of years, when the cocktail banter turns to the latest and greatest commodity investment, you'll be able to smile knowing you're already there.

P.S. You'll see something shortly on our new and improved website. You'll be able to access your account in real time, communicate with us, and catch up on interesting tidbits we find along the way.

Scorecard – Year to Date: Dow Jones Industrial Average -1.99%, S&P 500 +1.39%, Citigroup 5 yr. Investment Grade Bond +.17%