

# Manager writes: Why commodities?

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There are secular shifts taking place in global economies and in the financial arena, shifts which are resulting in tangible assets becoming more attractive than paper assets. As part of this tangible theme, commodities are now providing investors with an asset class that displays long term value and positive price catalysts. As an asset class, it is just coming out of a lengthy bear market that has lasted for 20 – 22 years, and which makes them look very cheap. In 2000, commodities were still at the same levels they were during the 1930's depression years in real term prices, and today they are still not far off those levels.

The last commodities bear market lasted from 1981 to 1999-01. It was a period that was characterized by oversupply, and slower demand growth. Moreover, there was a lot of inventories liquidation taking place. Global economies post-1990 have rarely grown in a synchronised manner, and commodity prices have been in a downtrend as a consequence.

This environment entered an extreme phase at the end of the 1990's, when the Asian crisis occurred and Asian demand collapsed. At the same time the former Soviet countries were liquidating their stockpiles in a race for strong currencies. It was at this point that the bottom of the secular down trend took place. Now, with three billion new capitalists entering the market economy in China, coupled with the developed world's established consumption habits, and a long period of sustained under investment in productive capacity, the environment is shifting to one of competition for natural resources, resulting in the start of a new secular bull market for this asset class.

## Historical perspective

Commodity markets have historically been through protracted up and down phases – just

as nature is cyclical, economies are cyclical, and investment is cyclical. Looking back over the past century, we can see that every 25 to 30 years supply and demand cycles lose their cohesion, inventories drop, and the monetary system starts to develop imbalances. These factors are positive drivers for a commodity bull market. There was a bull market in commodities from 1906 to 1920, then from 1933 to 1948, and again from 1969 to 1981.

The current bull market began in 1999, which, by historical standards, should see us into the middle of the next decade. These bull markets are sustained for years because supply is inelastic: it takes time and a willingness to invest to extract new resources, and to address supply imbalances. Commodities bull markets are no 'new thing' – they have been recurring over time when conditions were right, but they seem to be a once-a-generation occurrence. The current generation in the financial industry has not heard much about commodities, as most have focused on stocks and bonds and M&A during their careers. Lecturing about commodities in business school and on MBA programs these days is scarce, even though commodities are widely considered life necessities.

From an investor point of view, the current commodity bull market will provide above average returns just as a bull market in stocks has done. The Yale study of June 2004, 'Facts and Fantasies about commodities,' looks at commodities from 1959 to today, and demonstrates that the average performance an investor could expect from a basket of commodities is around 11% annually over this period. Bear markets offer below average returns, bull markets above average returns. Looking at the recent commodities bull market period, from 1999 to today, the asset class has demonstrated annualised returns of 18.9% as

per the Rogers International Commodities Index (RICI) performance, this without any gearing or leverage, just following a basic index strategy.

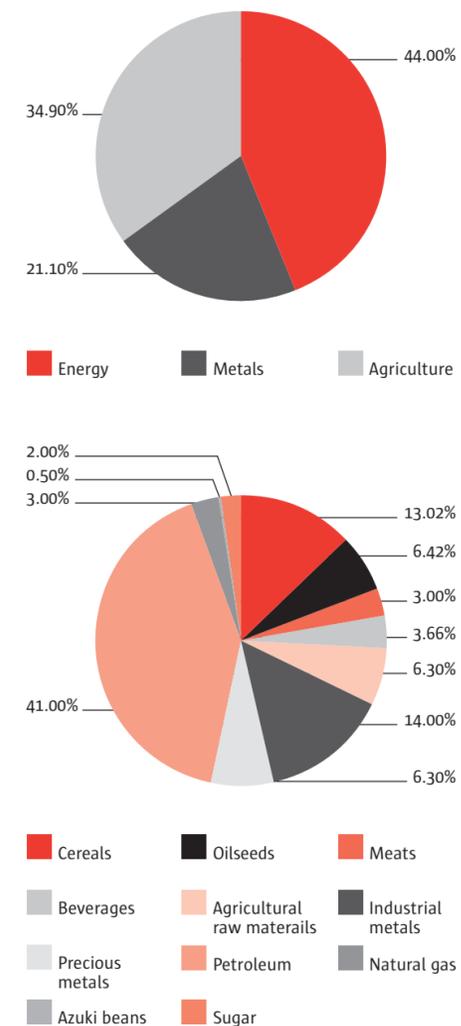
Of course, corrections and consolidations will occur from time to time. Markets don't go up and down in straight lines. There was a correction in commodity markets in 2000-2001, and commodity indices lost between 25 – 30 %, but the secular picture did not change, and in the meantime supply/demand/inventory/monetary imbalances grew bigger. As a consequence, prices rose higher after the correction. These types of corrections happen along the way in any bull market, whether it is stocks, bonds, currencies or commodities. These periods should be viewed by investors as opportunities to build up their exposure in an asset class where they have so far little portfolio exposure, and should not be viewed as a time to panic and disinvest. In fact, after the recent good run, we could be experiencing one of these phases over the next 6 to 12 months, one that should be viewed in this positive light.

The other aspect to consider is that commodities don't all move up and down at the same time, there are leads and lags in the behaviour of prices and segment leadership rotation. At Diapason Commodities Management we split the asset class into three segments: Energy, Metals and Agriculture. Since the beginning of this bull market, the leadership has been in the energy segment, which entered its up phase in 1999 and has offered a 1050% return as per the RICI Energy segment, whereas the laggard segment has been Agriculture, which only entered its up phase in 2001, and has offered a 25% return since then. These segments also react differently according to the various phases of the business cycle. Metals and energy segments are far more pro cyclical than agriculture, for example.

Although commodities segments and families can have their particular characteristics, what most commodities share is the rising cycle of demand, supply constraints due to under investment in previous decades, and diminishing inventories levels. Analysis of coffee, wheat, or corn stocks will reveal they have been decreasing over the past five years. This is true across all commodities at the moment. Interest in commodity projects is recent, and so far, even after a few years of rising prices, investment in productive capacity remains tame. For the publicly traded oil companies, new discoveries do not even cover the depletion of reserves. In the agriculture sector there are less hectares of wheat planted today than in 1980, and most of the good land is also already in production. During the bear market in commodities there was low investment, and the return on capital was low for producers; this is why capital was invested into other areas such as IT, biotechnology, distribution or banking, where the return on capital was higher.

Furthermore, all tangible assets tend to benefit in an environment of paper currency debasement. The monetary system has no anchor. It is an aging fiat monetary system and money supplies around the world have been expanding rapidly in an effort by central bankers to keep a financial system loaded with debt afloat. Deflation is the forbidden word. Every time there is an economic slowdown, a debt crisis, a hedge fund crisis, a Japanese deflation, a German reunification, a Y2k scare, the response from the central banks is the same: monetary expansion. However, producing 10,000 tonnes of copper by simply switching on the printing presses is not possible. If you don't have the infrastructure to produce it, you can't produce it. The value of money is reduced when compared with tangible assets, as their supply is limited, whereas the supply of paper money is not, and it has been growing fast.

RICI<sup>SM</sup> commodity index segments



Source: Diapason Commodities Management

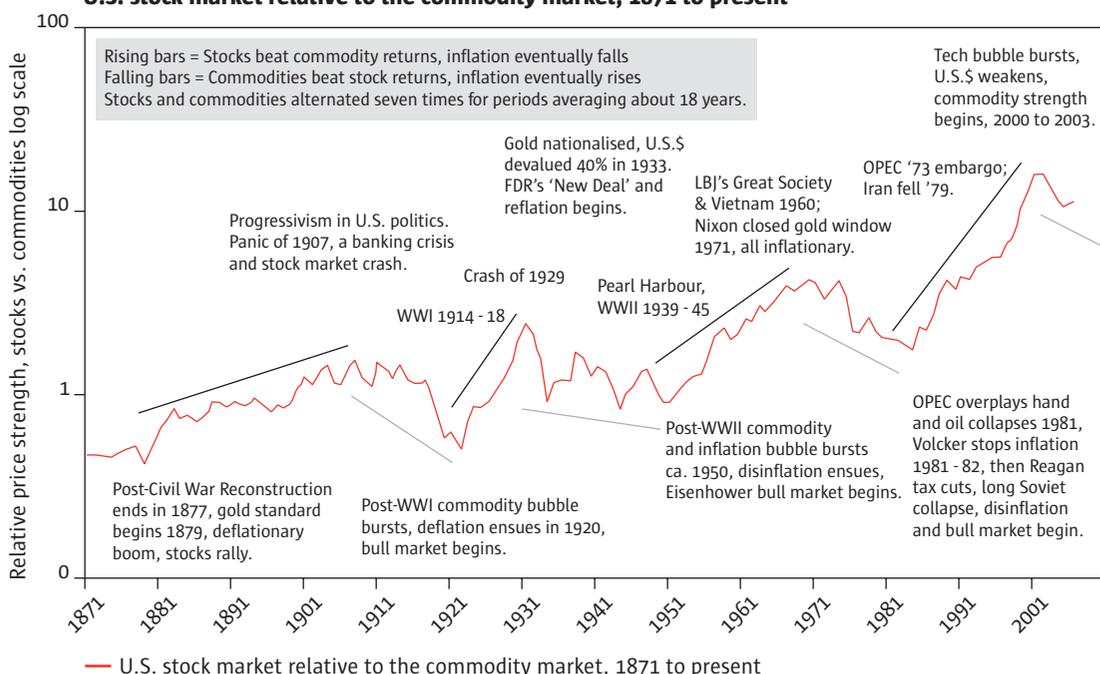
## Commodities today

Commodities are a true asset class, rather than just being a vehicle, and given the current market dynamics this is a crucial asset class to consider in terms of portfolio construction and asset allocation. Commodities are our everyday life, and in the current economic environment should be considered as an investment opportunity. Interest and investment flow from family offices, pension funds, banks, HNWI's, funds of funds, and asset managers is growing steadily.

When you are investing in an asset class, you want a vehicle that is representative of this asset class and reflects an economic reality, and that it is diversified, stable and well balanced. This has been the aim of the Rogers International Commodities Index (RICI) created by Jim Rogers in 1998. Its philosophy has been to remain as consistent as possible. The RICI includes 35 worldwide commodities, and as such is the broadest investable commodities index on the market. It includes commodities traded in Asia, Europe and America, so can be seen as globally representative, rather than being US centric. The RICI is balanced between energy, agriculture, and metals, in such a way that it represents consumption patterns. It is rebalanced monthly to initial weights, and there is an index committee that is monitoring the index and meets every year to review the components. In choosing an index for an asset class, investors choose the beta for the asset class, they want an index that is representative of this asset class with interesting financial characteristics.

Another advantage with investing in commodities is that they are characteristically very deep markets; liquidity is not much of an issue in relative terms. The yearly production of the 35 commodities in the index is around \$3trillion. Only a fraction of this amount is traded on exchanges and a significant portion

### U.S. stock market relative to the commodity market, 1871 to present



Source: ALL FORMATS BARRY BANNISTER, Legg Mason Wood Walker, Inc./Jim Rogers, Hot Commodities, New York, 2004, p. 21.

is also traded OTC. Interestingly, there is more and more flow shifting towards exchange trading volume; it is growing as the bull market develops and liquidity improves. Over the past 18 months there has been a 100% increase approximately in open interest across the various commodity exchanges. Historically, volume tends to increase with the bull trends.

#### Investment opportunities

When counterparties invest in the Diapason Rogers commodity index funds, our role as an investment manager is to track the RIC index. Therefore, our traders buy the appropriate futures contracts which they roll at the end

of the month prior to the first notice date. Thus we avoid any complications which may occur regarding the delivery process, and the investment remains in a pure financial instrument, enabling us to avoid the physical side of the business.

In terms of the amount which institutions should be investing in commodities, there are three drivers they should be considering. The first is performance. The second is diversification, because studies have shown that commodities are negatively correlated with financial assets; and thirdly, this is one of the only asset classes that will protect them as inflation reappears.

We are seeing many investors who start with a 5% allocation to commodities, then grow it to 10%, and over time, when they see opportunities and corrections within this bull market, they increase their exposure even further. Financial studies have also shown that including commodity exposure in a portfolio improves the efficient frontier.

Typically, we are seeing institutional investors taking a progressive approach to this asset class. As investors understand more about those markets, and in turn complete their research in this area, they often find that the index fund is the most appropriate vehicle for them. As they progress down the commodities route, they find they want to structure their exposure depending on their constraints in terms of risk and reward.

The Diapason Rogers commodity index funds are just one part of the story. We also have the capacity to develop structured products, which help investors to moderate this exposure or to implement it in the way they want. The advantage of structured products is that they are an open field to creativity. Depending on the requests of clients, who may want capital guarantee, leverage on the upside, cut their risk on the downside, or may want to accumulate over a certain period of time, we can offer various solutions. In this way, structured products can be a tailor made service.

**Diapason Commodities Management is a Swiss-incorporated firm that specialises in promoting and distributing products structured around commodities.**