A Soft Sell On Hard Assets

Even though steroids have been banned, sort of, in baseball, spring is arriving and the sap is rising both in maple trees and elsewhere. Natural impulses, combined with the first sustained commodity price rally in a quarter-century, have led to proclamations such as "copper prices can go anywhere."

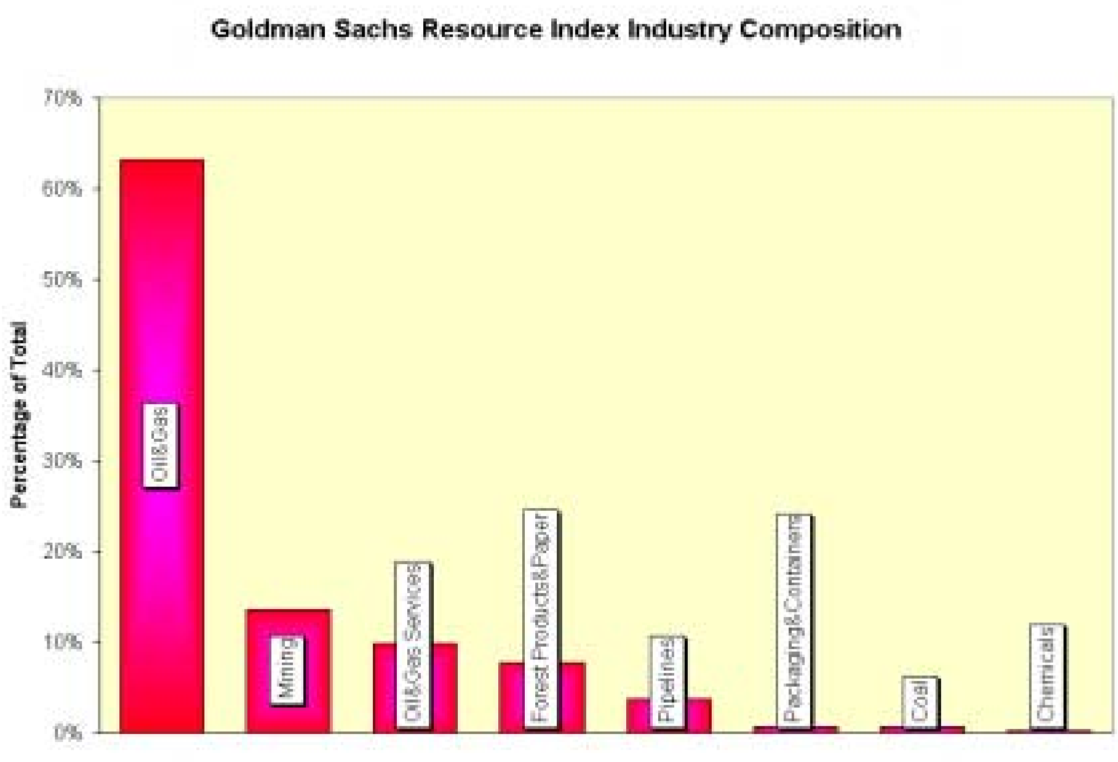
I normally will do my part for young love, but to ignore both history and economics simultaneously in the process is simply asking too much. Neither copper nor any other physical commodity can move beyond bounds defined by the operating margins of copper buyers on the upside and copper miners on the downside. As I noted in January 2002, commodity price rallies and downturns are self-correcting. The present higher prices for copper will encourage both substitution and outright demand destruction and will eventually lead to mine expansion. Just as the world is chock-full of methane, it is chock-full of copper and other metals in deposits such as seafloor manganese nodules uneconomic at present price, technology and international legal structures.

If you are looking for prices capable of going anywhere, look to individual equities. They are capable of rising several hundred percent a year, or falling 100% in a short period. Even equity indices can move further and faster than individual commodities, as the comparative price chart of copper and the Dow Jones Industrial Average, sans reinvested dividends, over the past century clearly depicts.

Do you have a need for speed? Bet on the tortoise of stocks, not the alleged hare of commodities.

Commodity-Linked Equities

If the capacity to add value lies with the commodity's producer, processor and distributor rather than with the commodity itself, a theme emphasized frequently in this space, then commodity-linked equities should be tempting. The Goldman Sachs Resource Index (GSR), the basis for the IGE exchange-traded fund, can serve as a reasonable approximation for such equities even though its composition of necessity is skewed toward the oil and gas sector with no distinction made between producers, refiners and integrated firms.



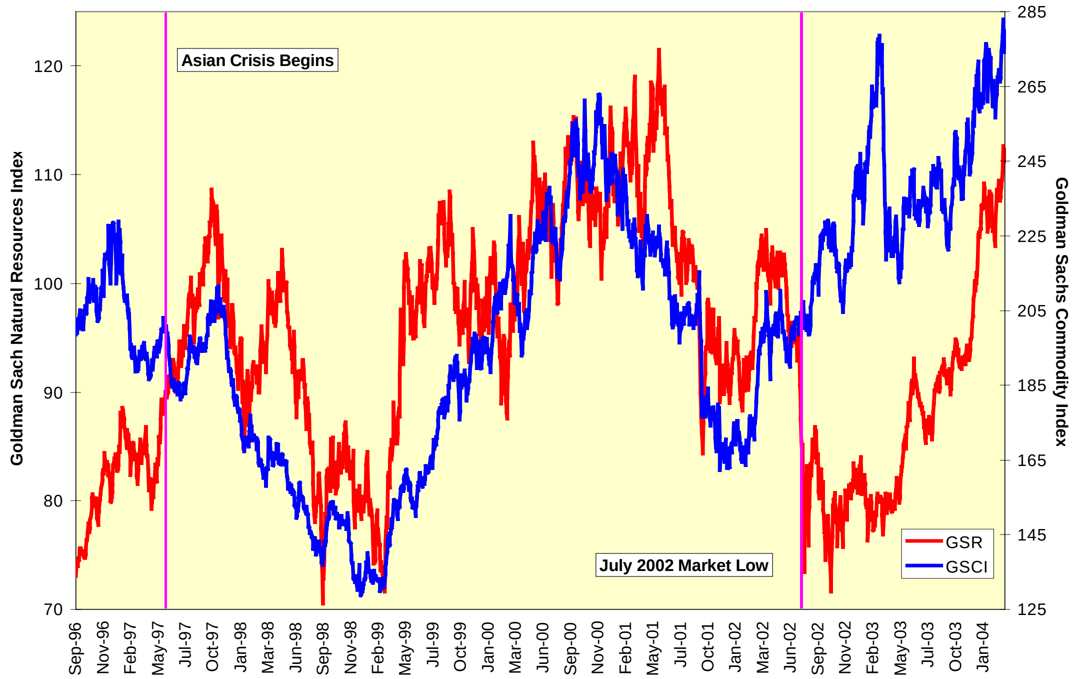
The lack of distinction between commodity producers and processors is more than quibbling on my part. The alpha, or expected outperformance relative to the broad market, of a commodity producer such as Newmont Mining tends to describe a call option's profit profile as a function of gold prices. The stock tends to rise in price earlier and faster than gold and tends to fall in price more slowly as higher-cost incremental production capacity is closed first.

This is not a universal relationship for commodity producers, however. The alpha of Phelps Dodge, for example, tends to describe the profit profile of a short put option on copper. As copper prices rise, the premium of the cash market to the futures market, or backwardation, tends to rise signaling an impending drop in the metal. Once this backwardation forms - which it has not yet done, meaning the metal's rally has further to go - the stock will underperform.

The alpha of commodity consumers such as DuPont or Dow Chemical in natural gas tends to have a complementary profit profile, that of a put option on the commodity. Higher feedstock prices squeeze operating margins and the stocks' alpha tends to lead natural gas price changes of an opposite sign by as much as three months.

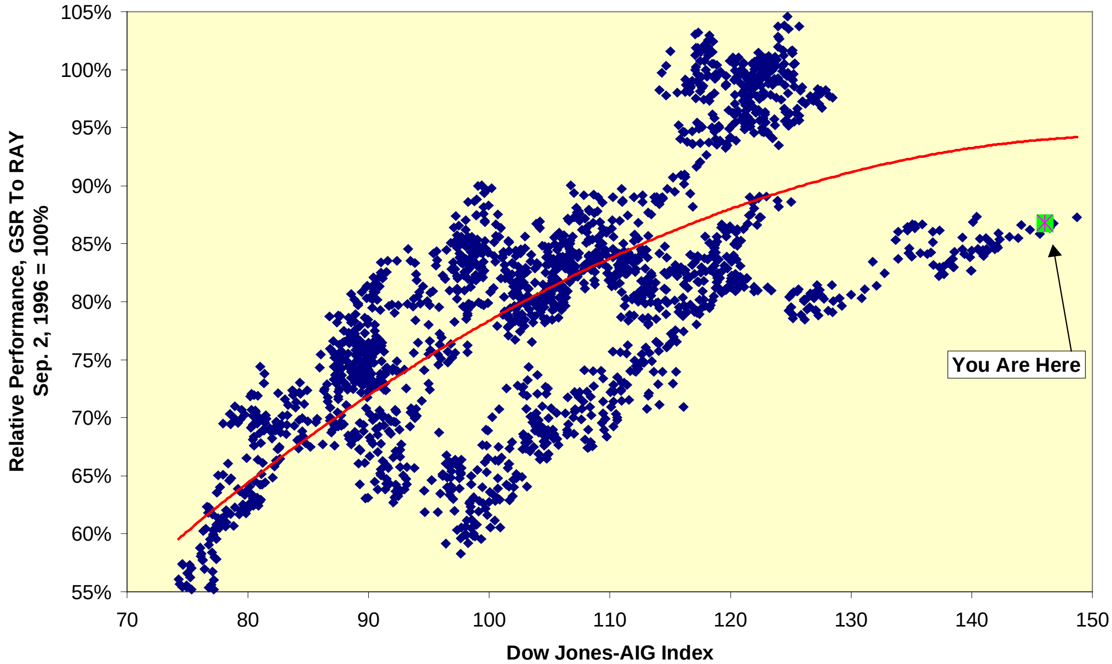
Blending various classes of commodity-linked equities into a single index produces a measure not at all parallel to an underlying commodity index. The GSR and the Goldman Sachs Commodity Index (GSCI), the most heavily energy-weighted of the commodity indices, paralleled each other roughly between the onset of the Asian crisis in 1997 and the July 2002 market low, but diverged both before and after. By the onset of the Iraq war / beginning of the present market rally, the divergence had grown to such an extent that a casual observer might have inferred an inverse relationship between the two. The GSR has rallied strongly since as oil prices have remained stubbornly high and as metal miners' stocks have firmed.

Commodities And Commodity-Linked Equities



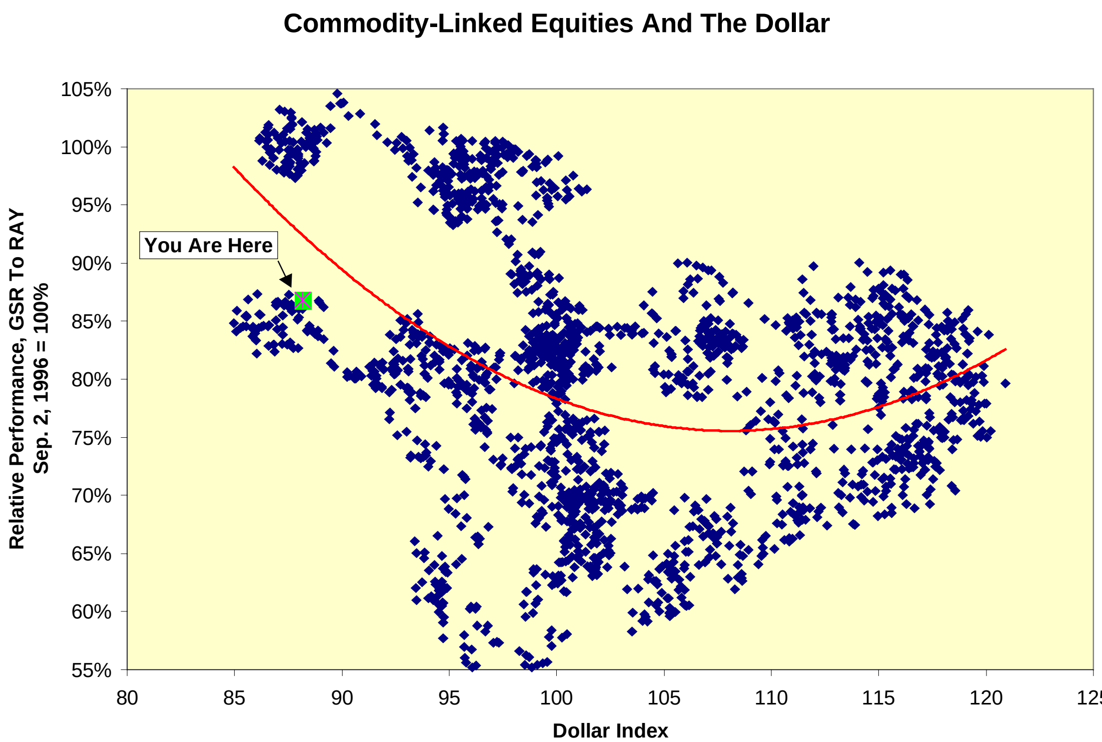
If we replace the energy-laden GSCI with the more balanced Dow Jones-AIG commodity index and display the GSR not on absolute terms but as a relative performance to the Russell 3000 index (RAY), we see the short put option profit profile expected of a firm such as Phelps Dodge. The GSR is not capturing the broad commodity rally completely.

Commodity-Linked Equities Underperform Commodities



Currency Effects

We should expect the GSR to get an alpha lift from dollar weakness; one implication of a weaker dollar is more of them are needed to claim a given quantity of physical assets. This indeed has been the case so far, but it is a double-edged sword. Unless the dollar continues to weaken - and my opinion is that it will strengthen on the back of a European rate cut - this effect has run its course.



Playing The Trend

The current commodity rally has more to go based on present supply/demand imbalances alone. However, and briefly, please be mindful of the risks. First, much of the rally has been propelled by China's growth surge, and given the history of previous booms and their 50% or so ratio of non-performing bank loans; they are due for some instability soon. The effects of the 1997-1998 Asian and Russian cries on commodity prices were both quick and considerable.

Second and debatably, inflation has not yet materialized despite the central banks' best efforts. The great commodity rally of the 1970s reflected inflation; it did not produce the inflation, and until inflation actually arrives any commodity rally will, as noted above, be self-correcting.

Third, if you want to trade commodities, trade commodities. Do not mess around with proxy variables such as the IGE. You can trade futures on the Dow Jones -AIG index, the CRB index and on the GSCI index at the Chicago Board of Trade, the New York Board of Trade and the Chicago Mercantile Exchange, respectively. Pimco's Commodity Real Return Strategy fund (PCRIX) and Oppenheimer's Real Asset fund (QRAAX) offer exposure to commodity prices. The former combines derivatives on the Dow Jones-AIG index with TIPS, the latter takes a more eclectic approach involving assets as diverse as corporate bonds.

The comparative performance since July 2002, when all three assets became available, is telling. The annualized total return on the IGE has been 12.25%. The QRAAX, with its more direct exposure has seen a 28.31% annualized return, while the Dow Jones-AIG index-linked PCRIX has enjoyed a 42.25% annualized return.