

Money Doesn't Grow On Trees. Coffee Does.

An old college roommate's mother asked her darling boy home for the holidays whether he needed anything from the grocery store. "Coffee," replied the diligent student. She came home with a jar of decaf.

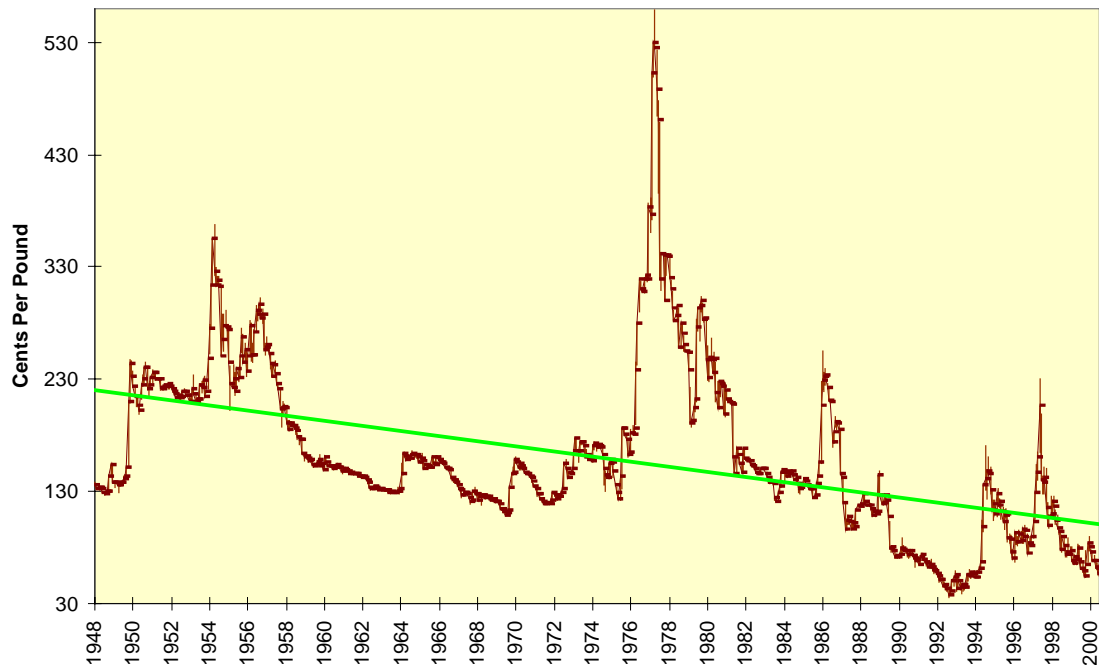
While coffee does not have quite the grip on its customers that tobacco does, it still occupies a special place in global commerce and is the leading legal source of foreign exchange for many of the coffee growing countries. In order to better their lot in life, many of these exporters have banded together to form the Association of Coffee Producing Countries (ACPC), an organization that strikes fear into the hearts of no one.

Coffee futures on arabica beans trade on the New York Coffee, Sugar, and Cocoa Exchange. This is the standard grade for most percolator and drip machines. The London Futures Exchange has a contract on robusta beans, used primarily for instant coffees. Here's some horrifying trivia: The specifications for the robusta contract note that a 500-gram sample cannot contain "more than 5 fully moldy or 10 partially moldy beans, such that the total exceeds 5 fully moldy beans." How's that for quality control!

Like so many commodities, coffee has been on a near-permanent real price decline punctuated by spectacular price spikes, as seen below. Most of these spikes are associated with frosts in the Brazilian highlands, which kill or stunt the trees. The futures made a seven-year low two weeks ago, and then rebounded 22.8% in just four trading days as a frost scare conveniently emerged. Half of this gain was then lost on the fifth day as the crop escaped damage.

These declining prices and high volatility may be unfortunate for the producers, but it should lead to healthy margins for the roasters who buy the reddish raw beans and turn them into dark brown beans familiar to consumers. Is there a way for us to make money from these unbalanced terms of trade?

Inflation-Adjusted Coffee Prices

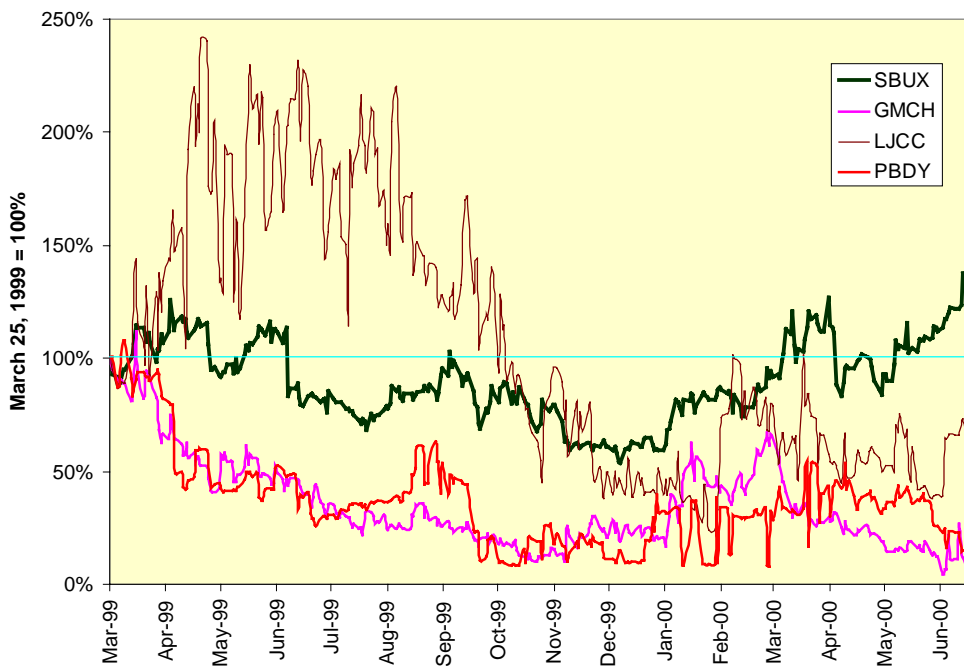


Is Perking Working?

From the equity point of view, not really. Finding pure coffee-related equities is difficult. Most of the major roasters are integrated food and consumer product giants such as Procter & Gamble, Nestle Foods and Philip Morris (through its Kraft General Foods group). Many coffee importers, distributors, and service providers are privately or closely-held. This leaves us with an interesting group, firms who are trying to add value to ground roasted coffee beans and hot water by selling convenience, a lifestyle image, and maybe a decent cup of joe.

Let's take a look at the relative performance of Gourmet's Choice Coffee, (GMCH) LaJolla Fresh Squeezed Coffee, (LJCC) Peabody's Coffee, (PBDY) and of course Starbucks (SBUX) since March 25, 1999, when data for all four became available. Instead of comparing them to the S&P 500, let's compare them to the Russell 2000 index. And, let's divide this relative performance by the declines in coffee prices to account for their lower feedstock -- coffee bean -- costs.

**Relative Performance To Russell 2000:
Selected Coffee Stocks Adjusted For Coffee Price Changes**



The results are not particularly encouraging for this quartet. Only Starbucks has managed to hold even with the Russell 2000 over this period, and even its present comparative level has required a 64.95% year-to-date gain to achieve. The labor and real estate costs of Starbucks are a far greater component of operating expenses than are raw coffee costs.

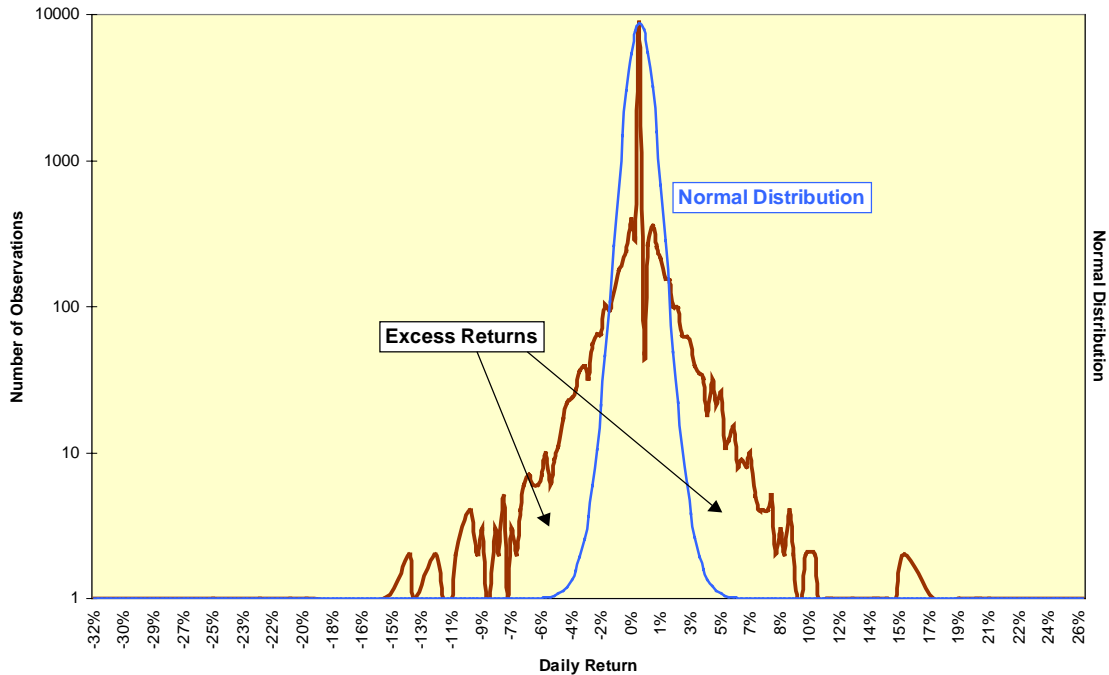
LaJolla, which produces cold-brewed liquid coffee extracts on purpose, much as my old roommate did by accident, had a brief period of hot performance in 1999, but has disappointed ever since. Gourmet's choice, which operates as a holding company for other beverage companies as well as a coffee chain operator, has a one-year total return of -73.68%. Peabody's Coffee, which operates coffee service kiosks, has a one-year total return of -56.00%.

It's a small wonder there are so few pure coffee plays: The costs of adding value via service are quite high, and the returns on these investments are quite low. This explains why the giant global coffee industry is dominated by state marketing boards and is tucked away in the subsidiary operations of large multinational food firms.

Back To The Futures

We made an observation two weeks ago (see "Oil Service Stocks Are No Way To Play Oil Prices, July 5, 2000) that if you want to trade commodity prices, then trade commodity prices. The same lesson applies to coffee, but with an interesting twist. Coffee futures are a day trader's fondest hopes. The market possess an extraordinary number of unusually large daily returns, as shown below, and within these large moves, there are a large number of "trend" days, those wonderful structures in which the market keeps heading off in one direction all day long.

Daily Coffee Returns, 1948 - 2000: Actual And Expected



And thus our conclusion: The coffee industry, from tree to Styrofoam cup, hasn't done well by running away from coffee's volatility. Maybe you can do better by running toward it.