Think Before You Link Stocks And Commodities

In a gold rush, sell shovels. That advice, in one form or another, no doubt preceded the California gold rush, but is there a better illustration of this axiom than the relative profits of various 49ers' and Levi Strauss, purveyor of blue jeans thereto?

Does it follow that in a modern-day commodity rally we should forego trading the underlying commodity and focus instead on the stocks of corporations involved in the production and processing (see "The Producers," "A Consuming Passion" and "Due Process For Commodities," June-August 2002) of those commodities? And given the surging popularity of exchange-traded funds (ETFs) linked to various sub-indexes, should any of those instruments earn our investment dollars the way various resource-oriented mutual funds once did?

Bound For Glory

The answer depends on your timeframe for trading and analysis. Commodity prices are bounded by process economics (see "Two Sides Of Different Coins," May 2002) over any timeframe longer than what is required for either or both supply or demand responses to materialize. Inside of that timeframe, be it weeks, months or even years, it may be accurate to say the price of a given commodity can "go anywhere."

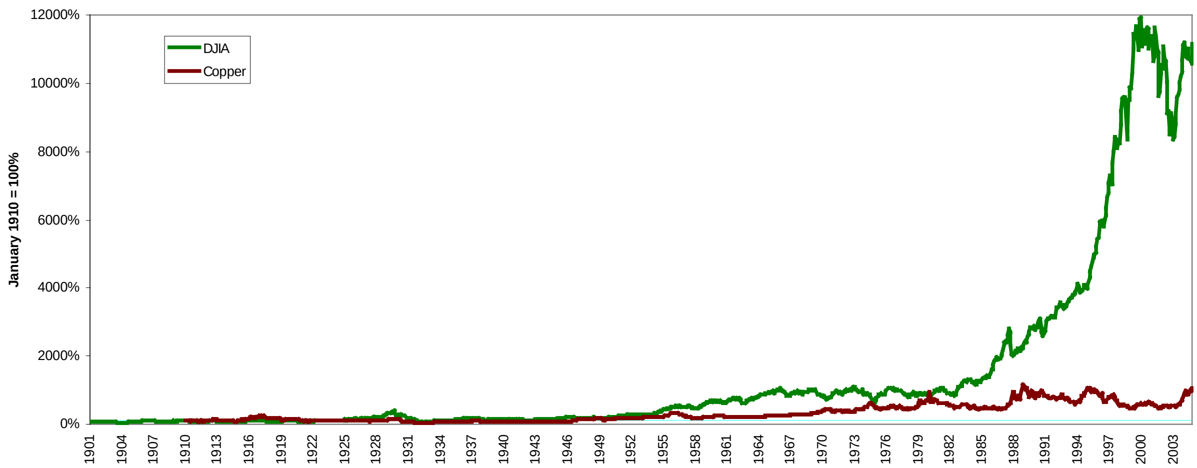
Outside of that timeframe, such a statement is not and cannot be correct for it would imply total price inelasticity of both supply and demand. Imagine what price of whale oil would be implied by such a state of affairs or what your own demand for various goods and services would be if they were priced at zero. Commodity price cycles are to a large extent self-correcting.

This hardly is the case for either equities or for equity indexes; the two have entirely different volatility and return distributions and should not be treated as one and the same underlying asset. An index going to zero represents, literally, an end-of-the-world scenario, one wherein no further action is necessary. An index can rise indefinitely, as we saw during the 1990s, but it soon will become unattractive relative to investment alternatives. Finally, an index can grow simply as a function of economic growth over time.

An individual stock can go to zero in the event of bankruptcy, it can disappear entirely through merger, and there is no evidence whatsoever of an upside limit on its price. In fact, by the perverse mechanics of indexation, demand for an individual stock actually may increase on both absolute and relative bases as its weight in various indexes, a lagging function of previous business successes, increases.

Over a long period of time, the ability of a stock or stock index to grow simply dwarfs that of an individual commodity, as seen in a comparison between the Dow Jones Industrial average, displayed without the considerable compounding effect of reinvested dividends or without the ameliorating effect of taxes, to copper over the past century.

Stocks Grow, Commodities Do Not

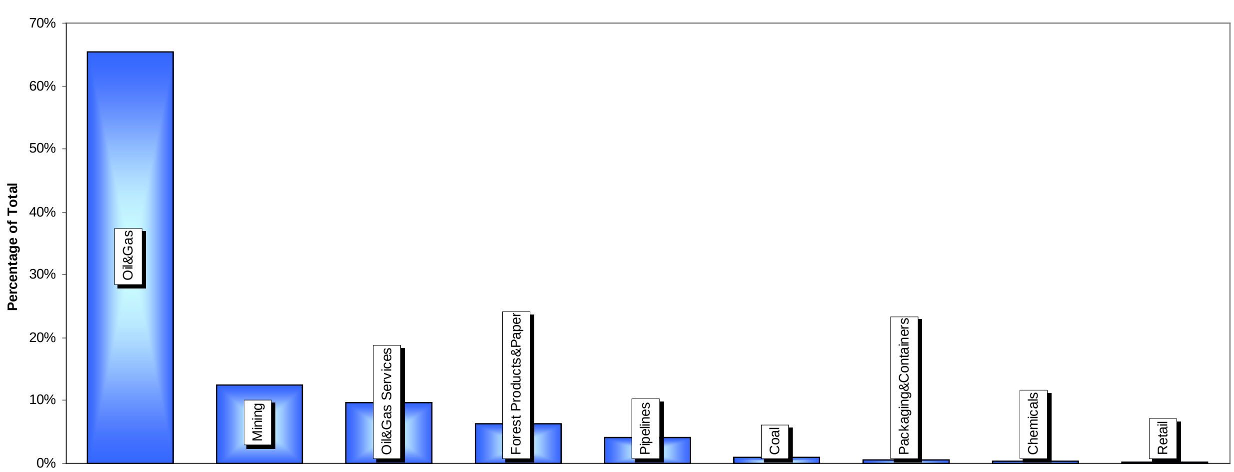


A Commodity Stock Index ETF

A dictionary search for the definition of "commodity-linked equity" is going to come up dry, which leaves the matter in the eyes of the beholder. While a reasonable argument could be made for dividing the potential portfolio into producers-only, processors-only and integrated companies-only, there are far too few bright lines dividing these categories. As an aside, similar coarse aggregations are found in most focused indexes; what, precisely, is a "technology" company?

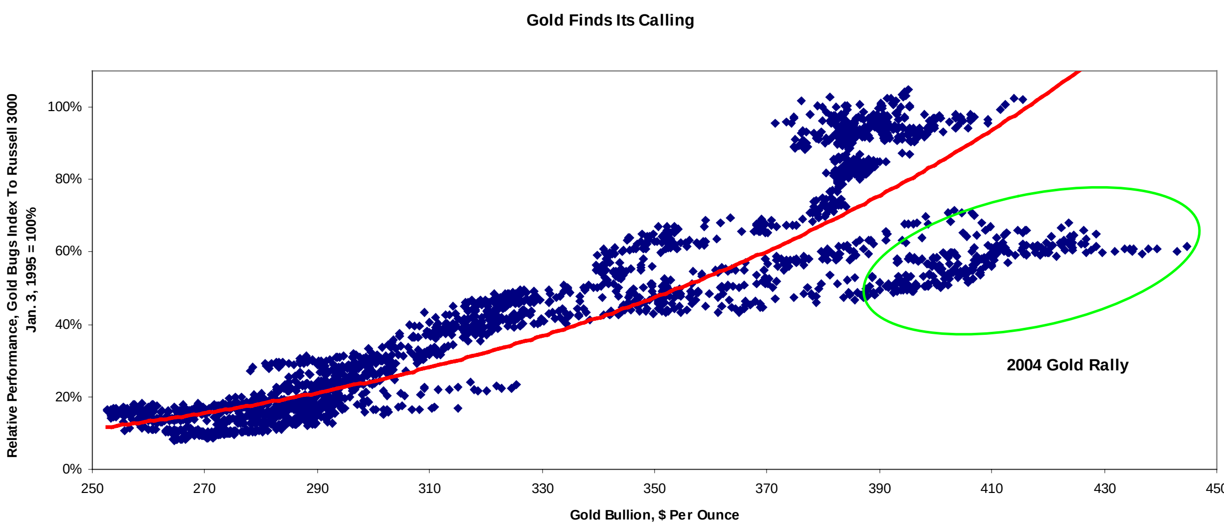
Morgan Stanley created a 20-member equal-weighted Commodity Related index (CRX), but the equal weighting scheme and small number of issues make this index non-representative of the relationship between commodities and the economy as a whole. Goldman Sachs created a modified capitalization-weighted index (GSR) that serves as the basis for the IGE exchange-traded fund. Its composition is of necessity skewed toward the oil and gas sector, and no distinction is made between producers, refiners and integrated firms.

Goldman Sachs Resource Index Industry Composition



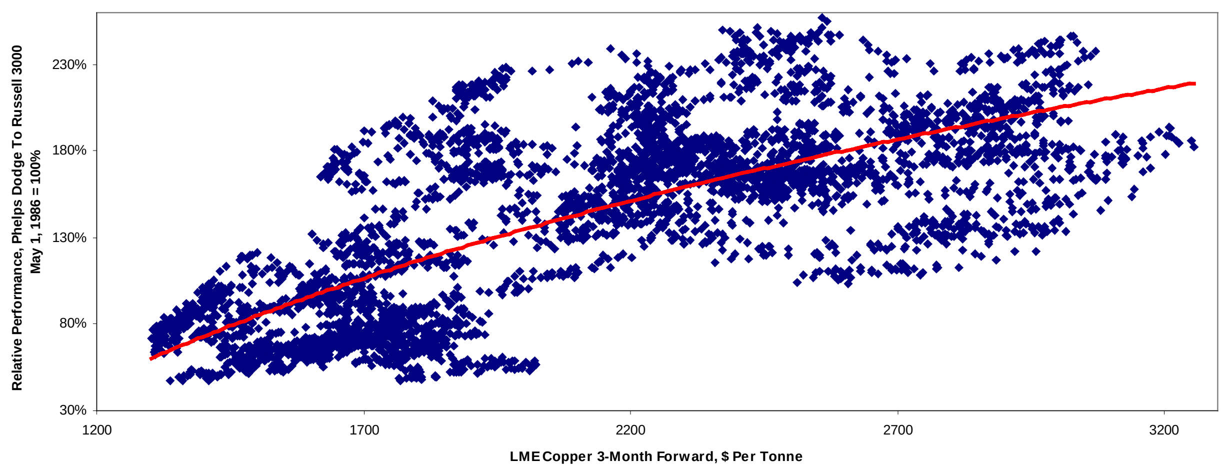
Even within the oil and gas group, the weightings are skewed toward the four global super-majors, ChevronTexaco, ExxonMobil, British Petroleum and Royal Dutch-Shell, which together combine for 65.4% of the index' capitalization. Their economic value derives in great deal from their logistics and infrastructure – the accounting term “goodwill” always seems a stretch in the oil industry – and is surprisingly resilient with respect to actual oil and gas prices. The drillers and service firms have a much tighter link to commodity prices, but the entire upstream segment of the industry accounts for only one-third of the GSR by weight.

The lack of distinction between commodity producers and processors is more than academic. We should expect each class of commodity-linked equity to have a different alpha, or expected outperformance relative to the broad market, as a function of its underlying commodity price. For example, the gold producers represented by the AMEX’ Gold Bugs index, firms who do not hedge their production more than 18 months out, have an alpha that prior to the 2004 rally in gold described a call option's profit profile as a function of gold prices. Traditionally, the stocks tended to rise in price earlier and faster than gold and tended to fall in price more slowly as higher-cost incremental production capacity is closed first. The 2004 underperformance reflected some skepticism regarding the ability of gold miners to sustain high margins within a continued gold rally.



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.

Copper Puts It To You

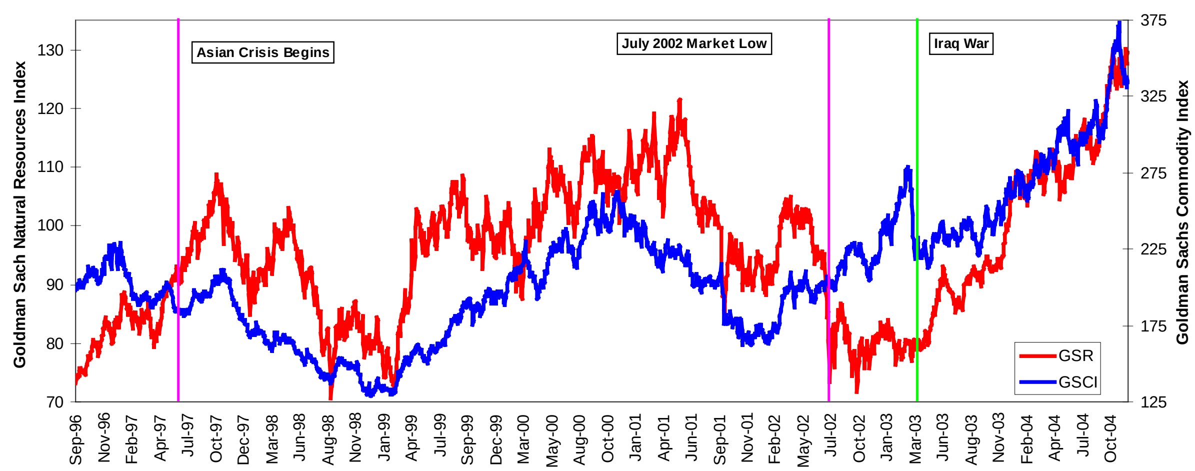


The alpha of commodity consumers such as DuPont or Dow Chemical with respect to natural gas tends to have a complementary profit profile, that of a put option on the commodity. Higher feedstock prices squeeze operating margins and the stocks' alpha tends to lead natural gas price changes of an opposite sign by as much as three months. This class of firm is not included in the GSR.

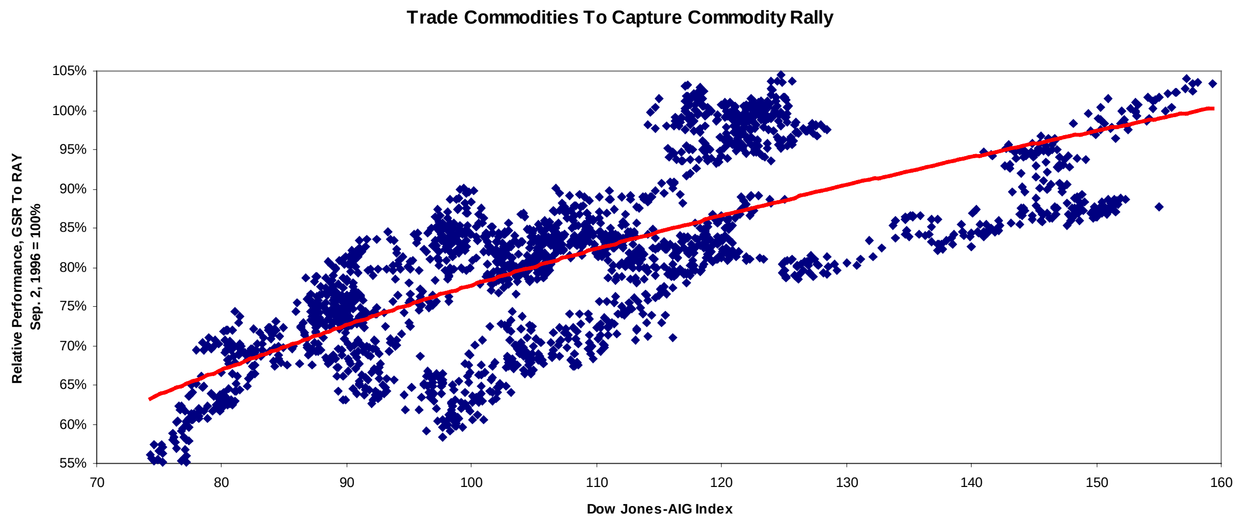
Index Comparisons

The blending of 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 indexes, 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 March 2003, which marked the onset of the Iraq war and the beginning of a stock market rally, the divergence had grown to such an extent that a casual observer might have inferred an inverse relationship between the two. Once global commodity demand and prices rose in late 2003 and throughout 2004, the movements of the two indexes began to reconverge.

Same Parent, Different Index Behavior

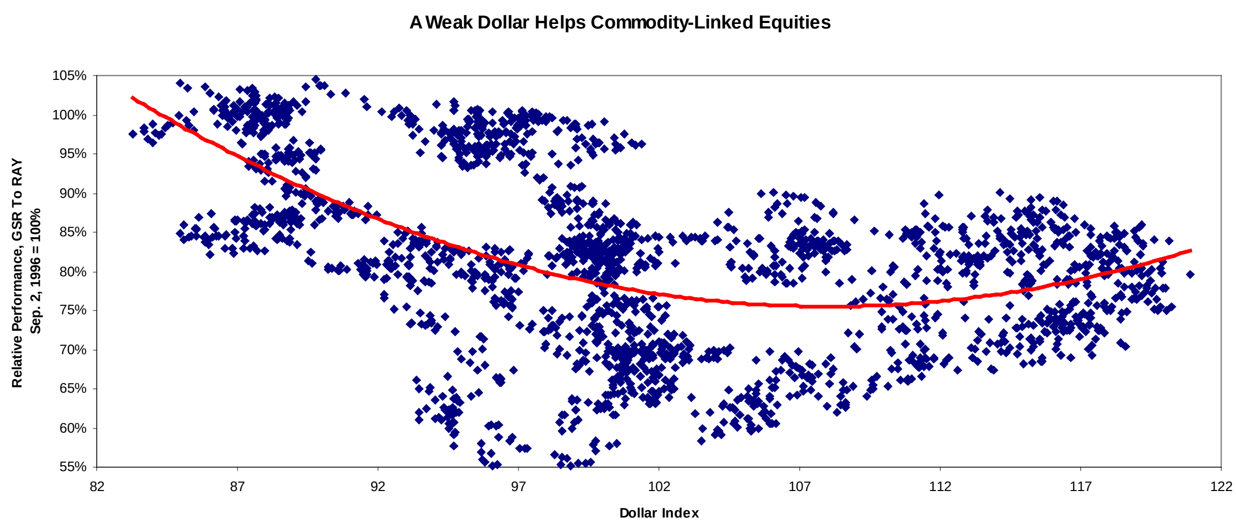


If we replace the energy-laden GSCI with the more balanced Dow Jones-AIG commodity index and display the GSR as an alpha to the Russell 3000 index (RAY), we see the short put option profit profile more common to a firm such as Phelps Dodge than to the call option seen for the gold miners. This is consistent with commodities being the purer way of playing a commodity rally than commodity-linked equities.



Currency Effects

Commodities in general are boosted by dollar weakness even though the opposite is not demonstrable for the currencies of commodity producers (see “Commodities + Currencies ≠ Commodity Currencies,” August 2004). We should expect, therefore, the GSR to get an alpha lift from dollar weakness, and that has been the case over the past eight years. Interestingly, a strong dollar, often corresponding to a strong economy and high interest rates, appears to boost the relative performance of the GSR.



Watch What You Trade

The 2003-2004 commodities rally, a natural consequence of monetary stimulus, (see “The Money’s Got To Go Somewhere,” April 2002) can continue on supply/demand imbalances alone. However, this is hardly a one-way trade.

Any disruption in China's growth surge, which would be consistent with the history of economic development, could derail things in a hurry. The 1997-1998 Asian and Russian crises hammered commodity prices quickly.

Second, significant inflation has yet to materialize. The great commodity rally of the 1970s reflected inflation; it did not produce the inflation. Until high and persistent inflation actually arrives any commodity rally will be self-correcting.

Finally, if you want to trade commodities, trade commodities. Proxy instruments such as the IGE reflect dynamics other than the prices of the underlying physical commodities. In addition to single commodity futures, you can trade commodity index futures on the Dow Jones -AIG index, the CRB index and on the GSCI index. Moreover, a number of interesting security products such as Pimco's Commodity Real Return Strategy fund and Oppenheimer's Real Asset fund offer exposure to commodities. 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.

Physical commodity traders ought to enjoy themselves over the next few years. Everyone deserves a rally every quarter-century.