Rain Makes Grain

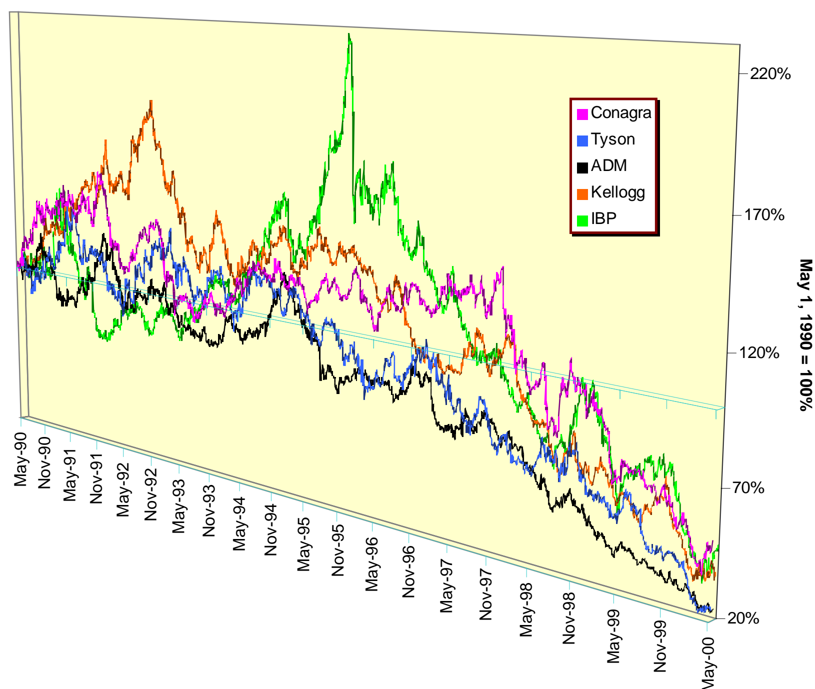
Roll out those lazy, hazy, crazy days of summer: What would summertime be without a weather market in the grains? Since 1999 produced nominal soybean prices at lows not touched since the first Nixon administration, it wasn't a bad bet we'd catch a rally or two in 2000. True to form, we've been having a planting season rally: If you really want to impress your city-dwelling friends, tell them Palmer soil moisture index readings are really low. Shake your head sadly and bite your lower lip for added effect.

Higher grain prices bring bad memories of the bad old days of the inflationary 1970s, and the last thing financial markets need these days is a further whiff of the dreaded I-word. But, when life hands you a lemon, make lemonade. Let's scout the horizon for stocks whose fortunes or misfortunes appear to be rooted in America's breadbasket.

First, let's summarize human history in a single sentence: People leave the land and don't return. We romanticize the farmer, but who's kidding whom? You're free to leave your desk tomorrow and buy a farm, but you won't: It's one of the toughest, riskiest businesses around.

The money in the food business is not in farming, it's in adding value as a processor. This includes converting grain into meat as well as converting corn into cornflakes or soybeans into salad dressing. Higher grain prices should, all else held equal, shrink the operating margins of these firms. Many of the largest food processors, such as Kraft General Foods, are now parts of conglomerates. Others, like Cargill, are privately held. We'll focus on a few more or less pure food-processing plays, such as Conagra, Kellogg, Archer Daniels Midland (ADM), Iowa Beef (IBP), and Tyson Foods.

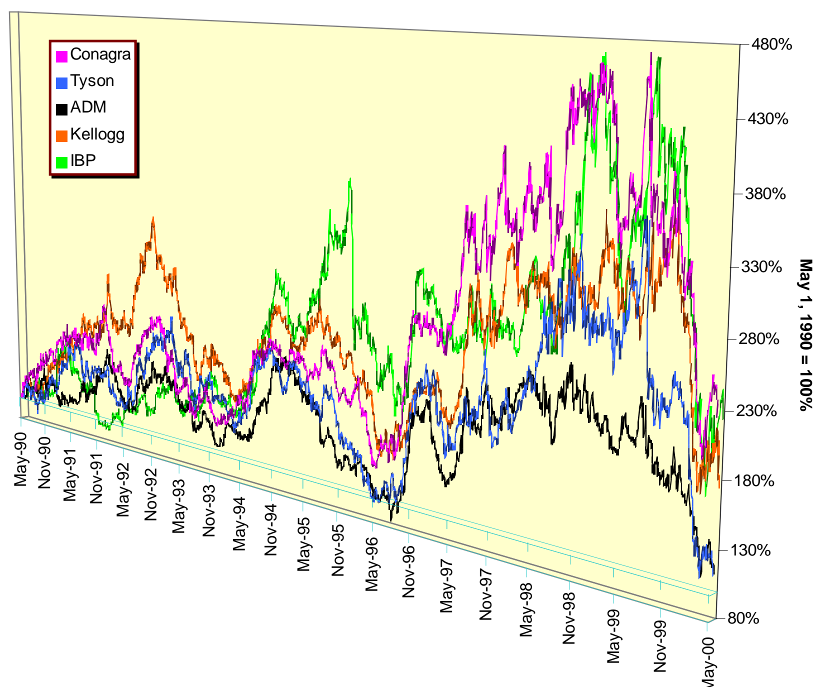
How has this group done relative to the S&P 500 over the past decade? Not well, especially over the past two years. Since May 1990, Conagra has been the best performer of this quintet, and it has shared in only 51% of the S&P 500's gain over the period. Tyson and ADM have shared less than 25% of the broad market's gain. In case you're wondering, that spike in IBP in late 1995 came on a surprising 74% jump in quarterly earnings followed -- and "followed" is the operative word here -- by analyst upgrades.



What makes this lackluster performance even more unsettling is that much of this underperformance came during a period of falling raw material prices. Tyson was feeding chickens very cheap corn, Conagra and IBP were feeding the same cheap corn to cattle and hogs, and so on throughout the industry. Now it is true that worldwide demand for meat and poultry took a beating during the Asian crisis -- you've got to eat, but you don't have to eat more expensive meat -- but the end of the downturn was in sight by early 1999. Markets are supposed to be discounting mechanisms, and if they were looking ahead to improved margins in the processing sector, it's certainly hard to see it from the above chart.

However, we can restate the above stock performances in terms of an index of 80% corn and 20% soymeal prices. Now we get a very different picture. The processing stocks rallied during the Asian crisis period, but have decline markedly since the late summer of 1999. Conagra and IBP, both of which purchase live cattle and hogs from independent producers as well as feed grains, have suffered the most as hog prices rallied from nominal dollar prices not seen since the Truman administration. The red meat packers (pork is a white meat only in an ad-man's dreams) got hit with a double-whammy of higher feed costs for their herds and higher live animal costs from third-party suppliers. Sounds like a great business.

Relative Movement of Food-Oriented Stocks To Feed Index



Refuge In Value?

These are classic value stocks. Tyson Foods, for example has a forward-looking P/E of 10.41 and a beta of .54 against the S&P 500. The respective figures for Kellogg are 15.49 and .43. The business of providing food products to the world is unlikely to disappear anytime soon, and most food processors have invested an enormous deal in creating brand identities for themselves and their products -- the sort of franchises that could bring a tear to Warren Buffett's eye.

But, they are caught in the commodity cycle. Higher commodity prices mean lower margins, and lower commodity prices mean abundant supplies and slack demand. This is an industry with little ability to create new markets and expand margins. If we are in a commodity price upswing at the moment -- and the jury's still out on that one -- don't look to these stocks for value. In fact, selling them against the S&P might be a chicken's (no pun intended) way of buying corn and soybean futures.

Many technology investors have been ridiculed for buying companies with no earnings, in sharp contrast to the sage value managers. As the comedian David Brenner used to say, "My brother is smart, so smart. I love my brother. I send him money every month."