Commodity Investing: No Against 'Em At The Forum

Successful investing, when you really get down to it, is nothing more than establishing a balance between running with the herd and avoiding a foolish commonality. It is not about being right in any objective sense - consider those who made fortunes on worthless companies during the 1990s - nor certainly is it about being right too early, a strategy often described as standing in front of a moving train. Only a small percentage of most fortunes have been established by being the first on board with the best idea. Far more money likely has been made in human history by selling too soon in a mania or buying too early in a panic.

These thoughts kept springing to mind last week when I was part of a panel assembled in Geneva entitled the Commodities Investors Forum. There were some items of consensus in the room, not the least of which was we are still in the early stages of a multi-year bull market in commodities. There were also some disingenuous arguments made on behalf of commodities that confuse past performance with future results, alleged to be a real no-no in this business.

Why Commodities: First, The Obvious

The reasons for such a bull market enjoyed no such consensus. There was the usual red meat approach of saying governments will debauch currencies, so buy gold and other inert stores of value. The Wall Street/City of London representatives' opinions can be summarized as saying we went through a long period of low investment in commodity production facilities and it will take multiple trillions of dollars (trillions with a "t," it was emphasized) of new investment to rectify this. New production will not arrive until the 2014 horizon at the earliest.

As an aside, the year 2014 promises to be an exciting one. This is the very same year pseudoscientific market technicians capable of adding 16 to the year of an earlier market peak or trough tell us will mark the takeoff point for the next great bull market cycle. Suspended animation until such a point arrives, alas, is not an option.

A petroleum geologist who gave a fairly convincing and sobering argument for the end of cheap oil by the middle of the century provided a major dissenting opinion from the low-investment model. This assessment, he emphasized, was not to be confused with an end to all fossil fuel discovery and usage, just the end of an era characterized by high net energy returns on investment in its discovery. In one of nature's many ironies, it takes a lot of energy to produce energy resources. Resources such as oil shale, Canadian oil sands, Venezuelan heavy oil and others demand very high energy inputs relative to output *at present levels of technology* [emphasis mine].

In his opinion, the high current prices are not the result of underinvestment, but rather that we have been looking for what no longer exists. Why he then had to end his presentation with a screed for massive global government controls and market interventions, including this gem, "End of 'freedom and democracy' as hijacked by commerce," I do not know.

Why Commodities: Second, The Disingenuous

The argument for investing in commodities based on price alone has certain self-defeating elements to it. In an argument made here several times before, commodity prices are bounded both on the upside and on the downside. Corn cannot go bankrupt, and as prices rise beyond a certain level, you cannot afford to feed it to cattle, hogs and chickens. Rising factor input costs, be they capital, labor, land or raw materials force both supply and demand responses that limit the further cost increases. Five thousand or so years of human history is pretty convincing in this regard.

So if the great Wall Street selling machine cannot promise you the moon on higher commodity prices, how can they promise you returns? The key step is to tell you the difference between investing in spot commodities, where the only dimension of return is the potential for price appreciation, and start investing in commodity futures, where an additional dimension, the forward curve, enters into the picture.

The principle behind this trade is normal backwardation, which is based on the idea that risk-averse commodity producers are willing to sell their production forward to risk-seeking speculators at a discount; this discount is a form of insurance. The discounted future must then converge to the cash market price prevailing at expiration. If the cash market stays stable or rises, the holder of the future captures the gain; if the cash market falls, however, the speculator loses.

Over time, the accumulated gains for a market such as crude oil, often in backwardation for reasons related to storage costs, supply disruptions and transportation constraints can be considerable. The losses for a commodity such as natural gas, where the discounted future often converges to a lower cash market price at expiration, can be considerable, too.

The Warning

Let's stop now and ask ourselves the question whether a large number of traders who identify this trade opportunity can exercise it simultaneously and with infinitely elastic liquidity. In other words, can everybody make money by capturing everybody else's inefficiencies? If a large number of traders are looking to sell the expiring January crude oil contract and buy the February crude oil contract, the realized "roll" will soon disappear and indeed has shown signs of disappearing so far in 2004.

An often-cited study of returns on commodity futures by Gary Gorton and Geert Rouwenhorst completed this past summer used historic commodity prices generated from the much-smaller and less deep and liquid futures markets of past decades. No adjustments were made for the limited capacity of these markets at the time, for the inevitable distortions of these markets that would arise from an observed trading pattern or for the very substantial loss of liquidity that would occur at the historic reported prices.

Futures markets, unlike equity markets, are a zero-sum game. If Keynes' theory of normal backwardation is correct, the accumulated gains of risk-seeking speculators cannot exceed the accumulated demand for price insurance from risk-averse producers. Two factors now arise. First, the capacity of the world's financial speculators exceeds that of the world's commodity producers by a large margin, no pun intended. Second, the very bull market in commodities predicted by so many, if it materializes, may serve to reduce the demand for price insurance by producers. The conclusion we can draw here is that increased investor demand for commodity exposure will encounter lower profit potential as the finite pool of insurance demand gets distributed over more insurance-providing speculators.

There will be money to be made in the commodity markets over the next decade. We will need to be careful, however, in identifying our sources of return and in learning more about the markets. This is an ongoing process. From what I saw in Geneva, there is work to be done.