Commodity Indices Continue To Struggle

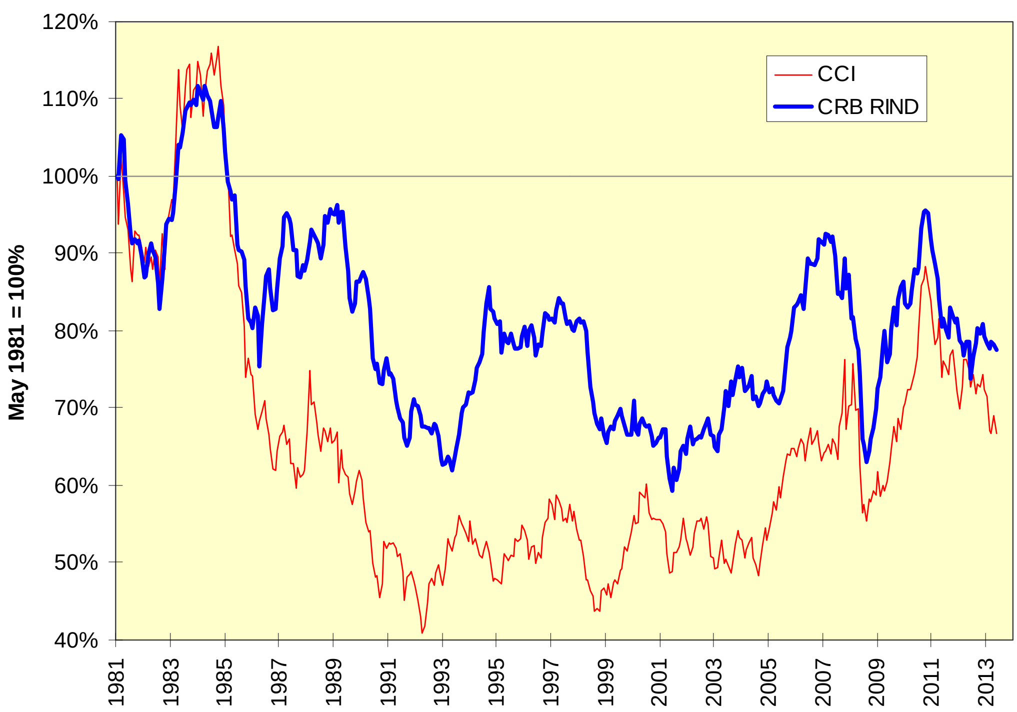
It is one of the more obscure anecdotes of pop music history: Bobby Fuller's classic *I Fought The Law* originally was entitled, "I fought the idea of long-only commodity indices as an investment, and it won." I bought the rights to the latter and the rest, they say, is history.

The idea physical commodities as a group or individual physical commodities taken separately can offer some measure of protection against inflation and/or currency debasement has a lot of appeal on the surface, but really has none underneath. The idea took a strong hold on investors' imaginations back in the 1970s when several years of inflation during the latter stages of the Vietnam War and the collapse of the Bretton Woods fixed exchange rate system preceded events such as the 1972 Soviet grain harvest failure, the 1973 collapse of the Peruvian anchovetta fishery, the U.S. soybean embargo and, most famous of all, the first oil shock of 1973-1974. Commodity price jumps followed inflation and policy failures, not vice-versa.

See Spot. See Spot Underperform

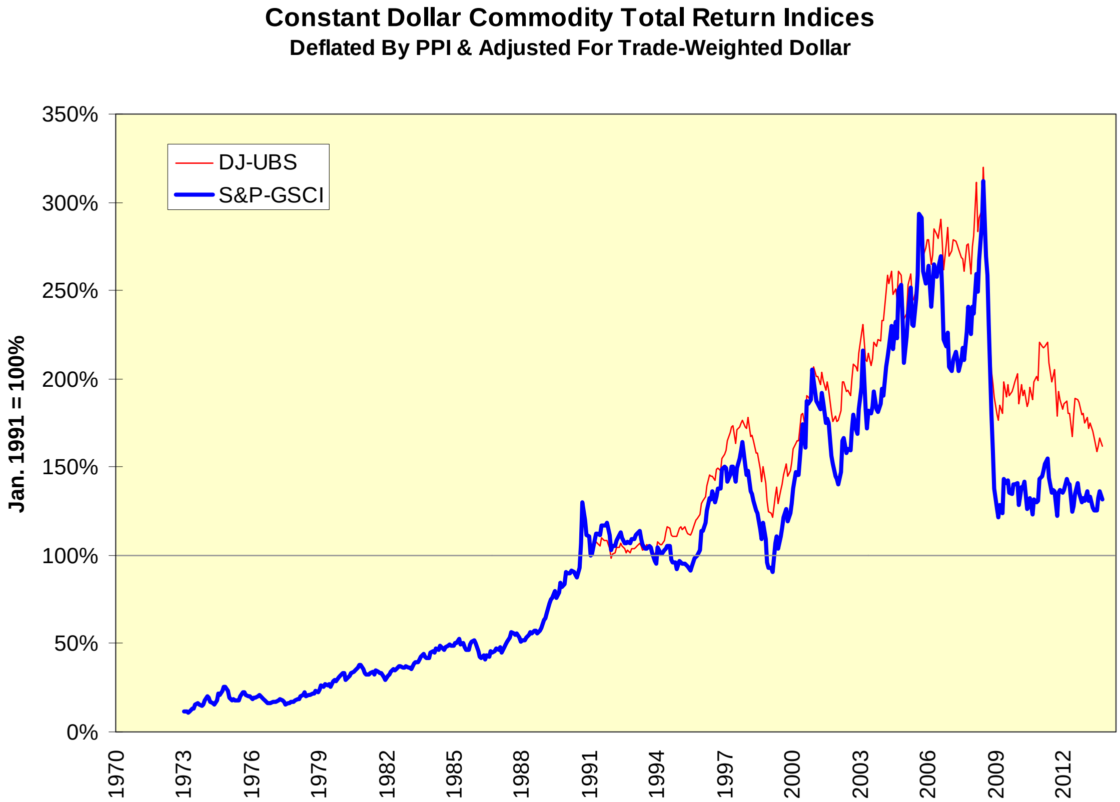
These price increases were doomed to be temporary, however. Higher prices for commodities both induce conservation and substitution on the demand side and new production on the supply side. The real price for these materials should fall over time no matter how much money is printed. Indeed, if we track the Continuous Commodity index (CCI), the successor to the CRB index and the CRB Raw Materials index (CRB RIND) since the May 1981 start-date of the latter, we find neither of them have been able to match the combined effects of the Producer Price index and the Federal Reserve's trade-weighted dollar index. Their adjusted average annual rates of decline have been 1.25% and 0.78%, respectively.

Constant Dollar Commodity Indices
Deflated By PPI & Adjusted For Trade-Weighted Dollar



See Total Return. See Total Return Underperform Totally

Let's move from spot indices to total return indices where the effects of contract rolls, rebalancing and return on collateral are added to the spot return. Here both the S&P-GSCI and Dow Jones-UBS total return indices have gained on an adjusted basis since the January 1991 start-date of the DJ-UBS index.



However, the base case for you the investor has to be other financial market alternatives and not the inflation indices. Here the commodity total indices underperform badly. While the adjusted S&P-GSCI and DJ-UBS indices have had average annual returns of 1.20% and 1.34%, respectively, since January 1991, the adjusted gains for three-month Treasury bills, 7-10 year Treasuries and the Russell 3000 have been 1.23%, 4.86% and 7.37%, respectively, on a total return basis. Restated, 7-10 year Treasuries have been a better defense against inflation and dollar debasement than have the commodity indices.

No one would have believed this in January 1991, especially if you had told them what would happen with federal finances. I would not want to bet on 7-10 year Treasuries outperforming over the next 22+ years given the low interest rate environment today, but I do believe equities definitely will outperform the commodity total return indices. After all, firms can and occasionally do add economic value via greater efficiency, but human ingenuity assures us real commodity prices should decline over time.