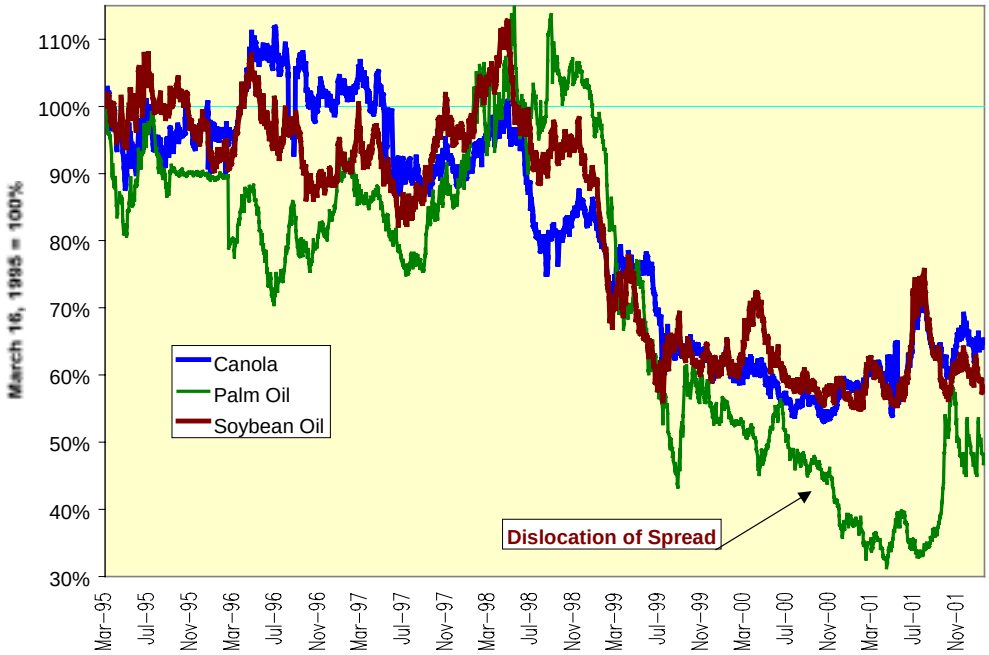
Palm Oil And Palm Pilots

Here's a prediction for you: Long after we forget what a personal digital assistant is, long after future archaeologists find your lost stylus and try unsuccessfully to fit it into a cuneiform tablet before they walk away shaking their heads, we'll still be using vast quantities of vegetable oils. Their inflation-adjusted price will be lower, too.

Not too many fats-and-oils traders wear flashy gold chains and sport other trappings of inelegant success, but don't let their workaday demeanor fool you. This is one brutal business: Every pound of soybean oil used is a pound of palm oil that wasn't. Anyone who works in a zero-sum game, like futures trading, knows how life's little niceties are checked at the door at the start of each business day.

All steady businesses, cutthroat or not, produce winners and losers. Let's see how different firms can either win or lose in this game after we check out where the prices of key edible oils have been on futures markets in recent years.

Oil Prices Stop Slip-Sliding Away



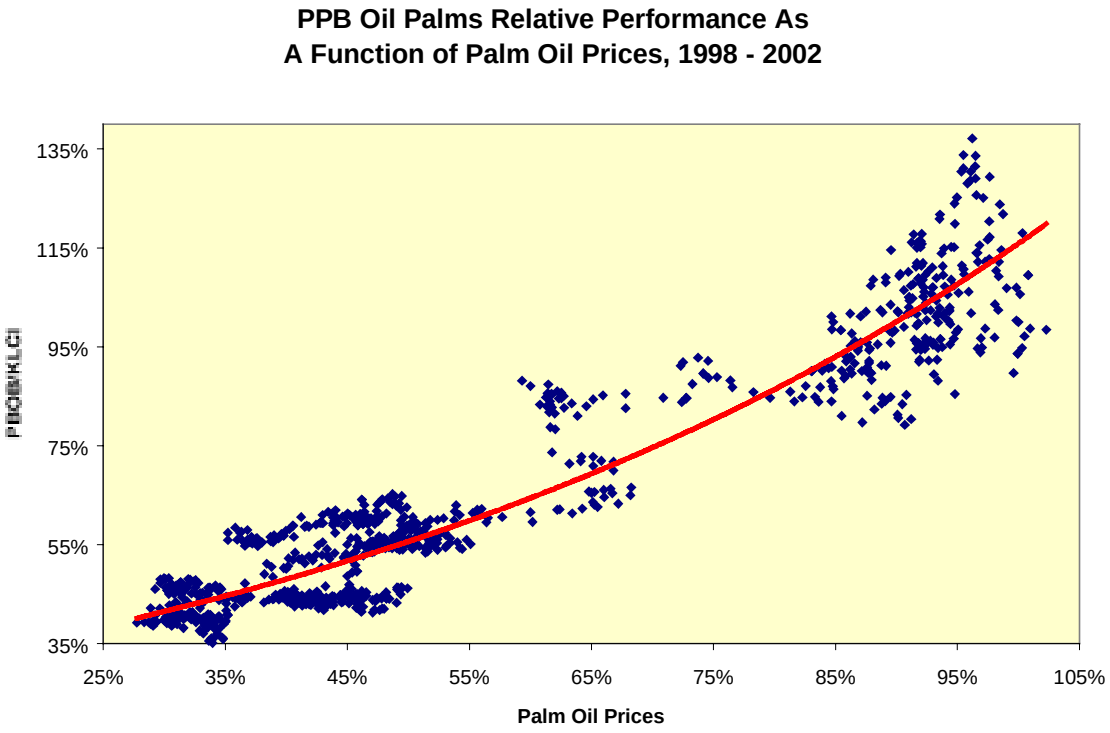
A Malay Waylay

The world's futures markets trade three principal edible oils. Palm oil trades in Malaysian ringgits on the Kuala Lumpur Commodity Exchange, soybean oil trades on the Chicago Board of Trade, and canola trades in Canadian dollars on the Winnipeg Commodity Exchange. Rapeseed, the precursor of the genetically modified canola, trades in euros on Euronext's MATIF division in Paris, but interest here is minor. Other key oils, such as corn, sunflower and cottonseed trade as spreads to these marker contracts. Animal fats, such as tallow and lard, have active cash markets, as does my all-time favorite, choice white grease – it's added to animal feed as a source of calories; remember, commodities are not pretty – but no futures contracts.

¿Remember El Niño and La Niña? They played havoc with palm oil production in 1997 and 1998. As if Malaysia and Indonesia didn't have enough problems with the collapses of their respective currencies, the ringgit and the rupiah in 1997, they faced a drought that reduced palm oil production. As commodity producers always do, farmers everywhere else expressed their solidarity with their South Asian counterparts by expanding production of oilseeds just in time for the heavy South Asian rains of La Niña. While soybean oil and canola moved in a tight spread to one another, the counter-seasonal palm oil moved into a heavy discount to recover market share.

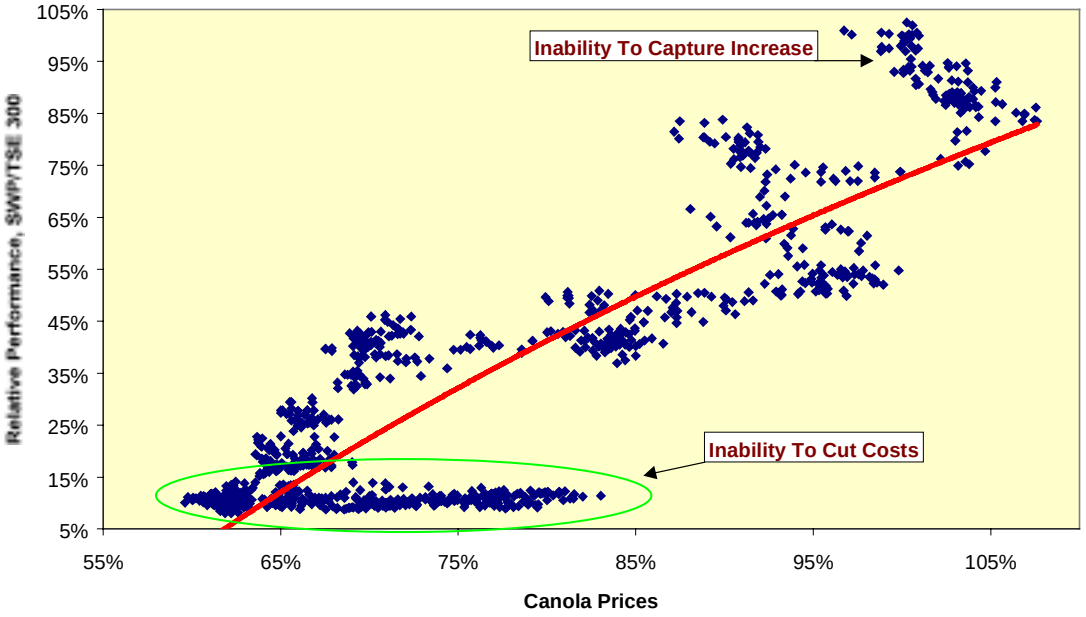
Three Sides Of The Business

You can be a producer, a value-added processor, or an entity like a state marketing board or farmers' cooperative in this business. Each one of these economic roles carries a different economic exposure to the price of commodities. Let's take a look at a palm oil producer, PPB Oil Palms, a Malaysian palm oil producer that has gained 64.2% in ringgit terms over the past year, as compared to a 2.4% loss for the Kuala Lumpur Composite index. If we plot the stock's performance relative to the KLCI as a function of palm oil prices – each dot in the chart below represents this relative performance against movement in palm oil prices – we see the classic commodity producer pattern. The red trendline looks like a call option's profit profile; as palm oil prices rise, we should expect the stock to rise at a faster rate, but we should expect the stock to be shielded on the downside as higher cost operations are closed.



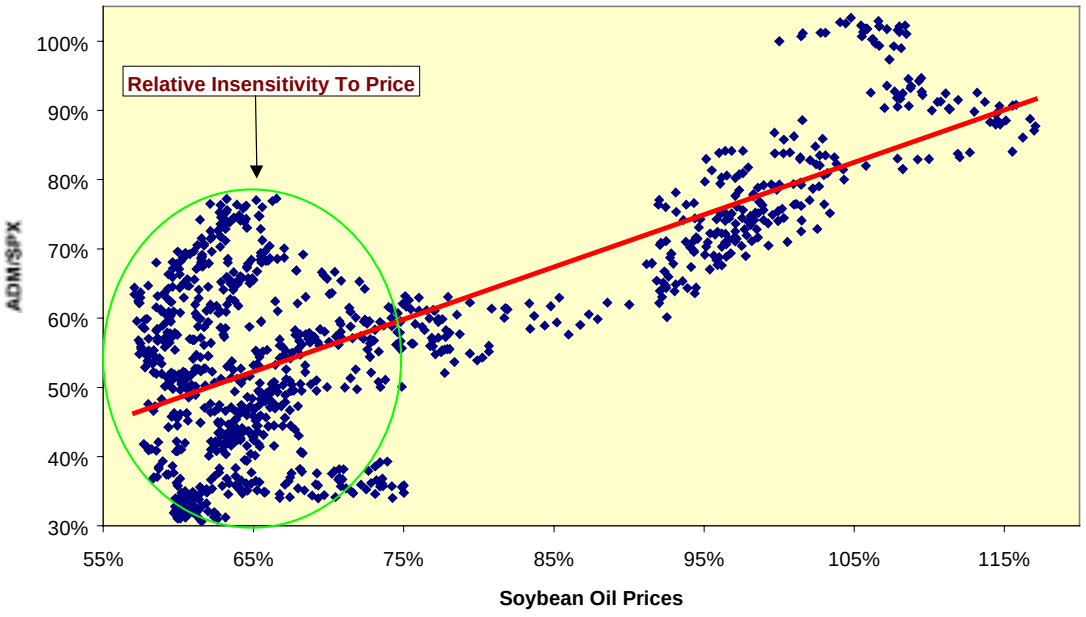
Now let's take a look at the state marketing board/cooperative situation. Here we can take the Saskatchewan Wheat Pool, a publicly traded firm with heavy canola exposure that has to pay attention to both provincial politics and Canadian national agricultural policies. As a result, it can neither cut back on costs when oil prices fall nor capture the benefits fully when prices rise. This is a worst of all possible worlds situation, and Saspool, as it's known on the prairies, has lost 16.6% in value over the past year, which is equal to the loss for the Toronto Stock Exchange 300 index.

Relative Performance of Saskatchewan Wheat Pool As A Function of Canola Prices, 1998 - 2002



Now let's conclude with a value-added processor, Archer-Daniels-Midland. This firm is involved in all aspects of the soybean crushing business, and its diversification and degree of vertical integration insulate it somewhat from the vagaries of commodity prices. At the low price levels seen for the soy complex in recent years, ADM's relative performance to the S&P 500 fluctuated over a wide range. Its relative stock performance in a rising commodity price market is somewhat linear as it faces higher feedstock costs along with its higher product revenues; its stock has fallen close to 6% over the past year, far better than the S&P 500's 16.8% loss.

Relative Performance of Archer-Daniels-Midland As A Function of Soybean Oil Prices, 1998 - 2002



If global commodity prices start to rise from a combination of monetary ease and economic recovery, the real gains are going to come from the primary producers. Should you even consider palm oil over Palm Pilots? Well, let's put it this way: Even though you'd rather be in technology than commodities for the long haul, only one of these choices fell more than 84% in the past year.