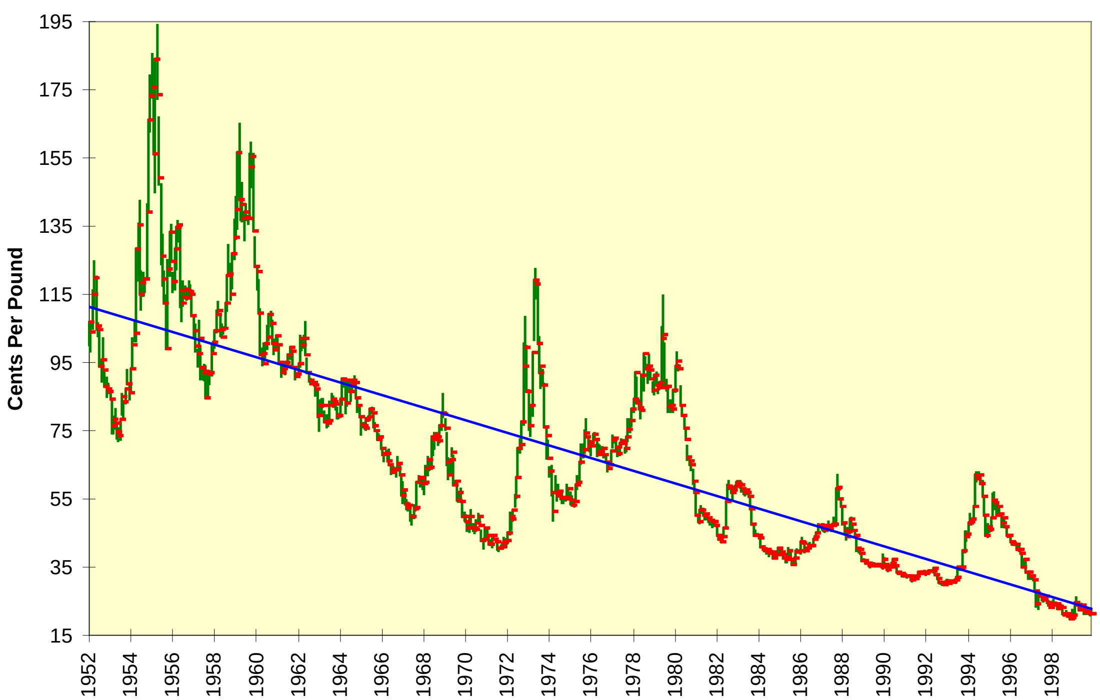
Where's The Bounce In Rubber?

Rubber, more than any other physical commodity, only makes news when it fails. Recent examples include the fatal Concorde crash allegedly caused by a blown-out tire getting sucked into a jet engine, and the massive recall of Bridgestone/Firestone tires for various SUV's. Even the tragic loss of the space shuttle Challenger could be traced to the failure of a rubber O-ring in cold weather.

Rubber, as discovered on many a prom night, is a strategic material. The synthetic rubber industry was born to satisfy the demands of the military; the loss of rubber plantations in the then-Dutch East Indies and British Malaya threatened to render the Allied war effort immobile. But in one of history's (and chemistry's) greatest ironies, the widespread adoption of radial tires increased the demands for the much superior natural rubber relative to synthetic substitutes. In fact, those high-performance airplane tires must be made from natural rubber. Did this surge in demand for natural rubber lead to higher prices? As readers of this series know by now, not a chance: The inflation-adjusted price of natural rubber is hovering near historic lows.

With a nearly straight line decline in real prices signaling massive increases in production efficiency, and with the world determined to keep on trucking, there's got to be a way to make a few dollars in this industry. Let's see where, and get ready for a surprise.

Inflation-Adjusted Price Of Smoked Rubber Sheets

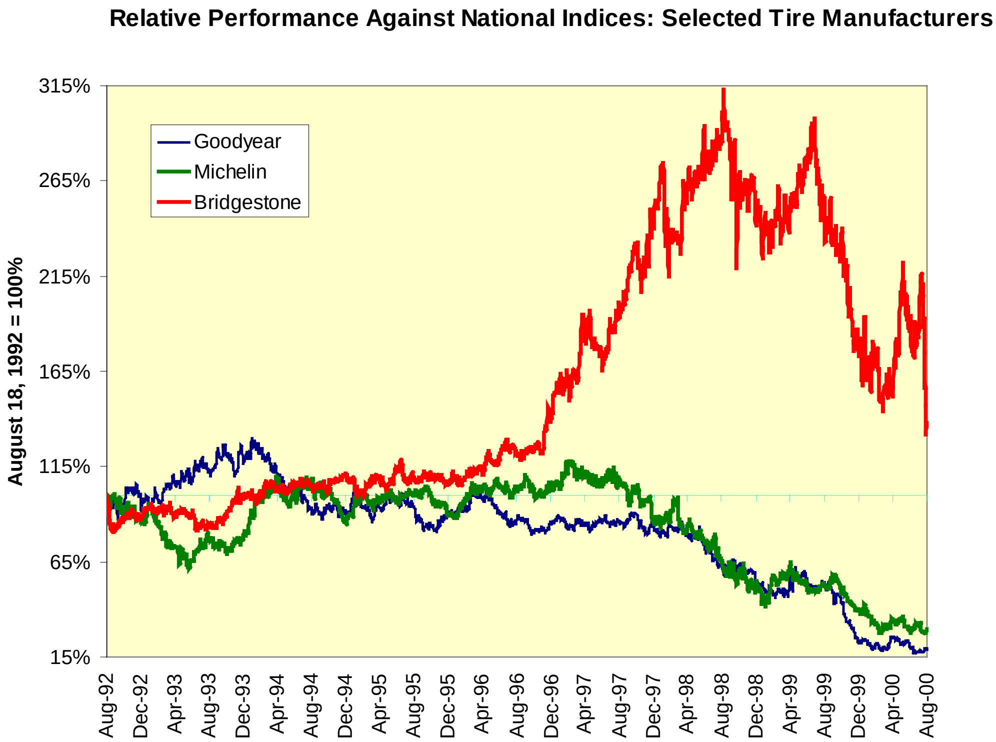


Don't Tread On Me

Tires are one of the few industrial products primarily purchased in the original equipment (OEM) market that have a significant direct consumer aftermarket. This requires tire manufacturers to maintain a retail marketing organization and spend heavily on consumer advertising; the Michelin man is one of the world's most recognized trademarks.   However, the bulk of their sales are to the heavily concentrated OEM market, which enjoys the purchasing power inherent in such a concentrated industry structure ("oligopsony," for you economics junkies). As a result, the tire industry had to counter with its own wave of consolidation. The Japanese firm Bridgestone acquired Firestone, B.F. Goodrich merged with Uniroyal, (the former U.S. Rubber, one of the original members of the Dow Jones Industrial Average, and as Old

Economy as you can get) and this combination was in turn acquired by Michelin. Goodyear Tire & Rubber, the last of the Akron, Ohio, rubber titans, remains an independent entity, but lost its membership in the DJIA in 1999, when upstarts like Microsoft and Intel were added.

How have these stocks performed against their respective national indices, the CAC for Michelin, the Nikkei for Bridgestone, and the S&P 500 for Goodyear?



The relative performances of Goodyear and Michelin have been similar and discouraging over the past eight years. Goodyear has captured only 20% of the S&P 500's gain over this period, and Michelin just 29% of the CAC's gain. Bridgestone has been quite a different story. Not only did it escape the Nikkei's treadmill -- this moribund market is trading at levels first reached in March 1986 -- it managed to treble the Nikkei's gains by August 1998. Since then, the stock has struggled, and it was on a downward path even before its present difficulties.

Tire manufacture may be a great business, but as we saw in the case of paper and forest products, (see "Beaten To A Pulp," August 1, 2000) it does not seem to produce great stocks. If anyone believes the industry will emerge better for its impending encounter with the American legal system, please see me immediately.

The Rubber Band

Well, somebody somewhere must be making money from natural rubber, and since the commodity is produced on massive plantations in modern Indonesia and Malaysia, (and traded on both the Singapore and Osaka commodity exchanges) maybe we should investigate the performance of some of the larger publicly-traded plantations. And, before you scoff at colonial pretensions, please investigate the stock tables in such august publications as *The Financial Times* and *The Economist*: They list plantations as an investment class.

My tonic, please!

Given the extreme volatility of such currencies as the Malaysian ringgit, Indonesian rupiah, and Thai baht, to name a few, we should focus on firms denominated in convertible currencies such as the British pound. Also, many plantations are diversified both geographically and across tropical products in order to minimize risk.

Let's take a look at Singapore Para Rubber Estates, which is traded on the London Stock Exchange and denominated in British pounds. Over the past year, this stock has returned 61.4%, and is still trading at less than half of its mid-1997 price. Or, we can look at the slightly more diversified Rowe Evans Investments, which has returned 26.2%. Narborough Plantations has returned 17.9%. Since it is common for the price of resource-linked equities to rise before the price of the underlying commodity does, we can interpret these returns as a signal for rising natural rubber prices.

As we have seen, it is rare for the primary producer to capture the gains from higher prices. Given the strong demand for natural rubber and the inability of tire manufacturers to battle either vehicle manufacturers or consumers successfully, it wouldn't be a stretch for the plantations to emerge as winners.