Lies, Damned Lies And Wall Street

Is there a more honored role to play in any gathering of practitioners than the designated skeptic? No, which is why I was so flattered to occupy such a slot at last week's "Portfolio Diversification With Commodities" conference in London. Skepticism's just another word for intellectual honesty, a commodity in short supply whose price never seems to rise. What does that static price imply for the *demand* for intellectual honesty?

For what little it is worth, the actual title of my presentation was "A Sceptical View," but the British did me the favour of using the American spelling.

A central problem faced by global investment managers right now is a growing demand for stable and long-term investment returns – think pension funds, life insurance and Social Security – and a growing shortage of reasonable sources from whence to derive them. Gone, for the time being, are the days when anyone could get double-digit returns in stocks simply by showing up and declaring fealty to the principle of long-term investing. A duplication of the fixed-income returns of the past two decades is virtually impossible mathematically, and real estate, as you may have heard, is not cheap.

More Risk Please, Sir

Just as cats are attuned to horizontal motion and sharks to blood in the water, investors are attracted to past returns and the financial service industry is designed to provide products to satisfy investors' demands. There is nothing inherently wrong with this so long as investors understand the perils of chasing return and the sell-side both understands *and cares* that they may not be doing their customers a favor by taking an idea with recently successful performance and beating it into the dirt. While neither development is likely to occur while humans trod the planet, we all must remember that the world can be changed by in small ways one step at a time. Otherwise, what's the point?

The recent success of commodities at the very time when traditional investments have hit a wall has produced the usual Pavlovian reaction on Wall Street. Many of the arguments presented on behalf of commodities as an investment class were the same as presented at a similar conference held last December in Geneva, but with some notable and telling differences.

Several speakers noted that the entire total return in commodities since 1994 can be attributed to crude oil. Not some of the gain, all of the gain. However, much of those gains until 2003 did not come from price appreciation, but rather from the accumulated capture of backwardation in crude oil futures. This gain, which is created by producers' demand for insurance, has disappeared as more and more long-only indexed commodity funds entered the market, as discussed here in April.

The failure of this return source, predicted here in that December column, opened the way for some tap-dancing worthy of Bill "Bojangles" Robinson. Proposals were offered to change the monthly contract rolls from the 5th through 9th days of the month to the 1st through 4th days, to roll from the front month to anything but the second month, etc. No one admitted the problem was a bad idea whose folly had been shown; no, the problem could and would be solved by modern data-mining techniques. There's no crying in baseball and there are no mulligans in investing. If you cannot present a hypothesis *a priori*, provide theoretical justification therefor and then confirm the theory with empirical data *ex-post*, you are a guiding light for the gullible, nothing more.

Just so you do not think I am being mean and nasty in an unsubstantiated fashion, let's do some back-of-the-envelope math. The average backwardation in crude oil between 1990 and May 2003, the mission-accomplished date in the Iraq War, was .57%. Now let's accept the bandied-about figure of $50 billion in indexed commodity investments. The current open interest in July crude oil futures is equivalent to 222.634 million barrels. If we said all of the indexed money was in the energy-laden Goldman Sachs index, which is 28.73% NYMEX crude oil, the potential insurance return using the .57% long-term average is [.0057 * 222,634,000] / [.2873 * $50 billion]. This works out to a lusty potential return of .0088% per month before transaction costs and fees. Of course, the present backwardation is -.974%, so the participants in this strategy are pretty much staring another loss in the face.

A third common theme among the non-skeptics was the proper way to construct and rebalance a commodity index. Representative of Goldman Sachs, Dow Jones-AIG, Standard & Poor's, Jefferies/CRB and Deutsche Bank argued – and this might surprise you – for the innate superiority of their methodology. Here let's recall a study done a number of years back on the Merck Manual, a desk reference published for physicians by the pharmaceutical giant.

The authors found that the less was known about a disease, the more alternatives were offered in the Merck Manual. This is easy to prove in the negative: If someone is bleeding, the first aid is to stop the bleeding. Nothing fancier is indicated. If we knew more about commodity indices – and I suggested in May 2004 indexation is a wholly inappropriate approach to commodities – we would not be so busy in constructing alternative approaches.

The subject of when to rebalance the weights in the index was addressed by one speaker, an index representative. A large data-mining study indicated the optimal time to rebalance was 18 months. The index rebalances every year. Why do a study and present it in front of a professional audience and then admit that not even your own firm uses your work?

Why Index?

The net result of all this is to beg the question of why force unrelated assets, such as the different commodities, into an index at all? The data are irrefutable: All of the gains derive from a single commodity, crude oil, and the gains in this commodity, as noted here in June 2004, may depress the gains in other commodities. Goldman Sachs even went so far as to entitle their presentation, "Why The GSCI Does Not Have Enough Energy." The Goldman Sachs Commodity index, in case you are interested, is weighted 73.52% in energy commodities.

The answer is thirty years after Burton Malkiel took his random walk down Wall Street, investors are convinced in the power of indices and investment analysts are addicted to benchmarking managers to those indices. Never mind the profound differences between stocks and commodities noted here in January 2002, few investors understand them and even fewer Wall Street sellers want to get education in the way of a good story: Hot commodities and all that. It is an index, therefore it must be legitimate.

The related question of why commodity indices are long-only devices is related to the financial world's inherent bias against short positions.

The sad part of it all from the perspective of one who has been in the futures industry for more than two decades is commodities can and do have a place in investor portfolios if done properly. But commodities are and always will be held to a different standard, and a short-sighted bungling of the best opportunity ever to move into the front ranks of investments will lead to relegation to second-class status if and when traditional investments regain their footing. At least that's the skeptical view.