Chapter One

Calling on Commodities

Why Commodity Investing Is a Savvy Bet

A MASSIVE BULL MARKET IN COMMODITIES is about to wash up on our shores, powered not by the stagnating West, but by a surging Asia. The big money of the next decade won't be made in bonds or real estate, and certainly not in the so-called U.S. blue chip stocks—it will be made in commodities. Savvy investors know that following global growth where it's going—as opposed to where it's been—is *the* winning bet. And as economic influence continues to shift toward the East, the smart money is investing in the basic raw materials that support economic growth—commodities.

A rapid reordering of the global economic pecking order is underway. In 1987, one-third of the world's economic output came from developing economies and two-thirds came from developed economies. By the end of 2009, their contributions were evenly split. By 2020, two-thirds of the world's economic activity will come from developing economies, while the so-called rich economies will be responsible for just one-third. The pace of economic change we are witnessing is both unparalleled and unprecedented.

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Commodities are *real* things that we rely on every day. From the time we get up to the time we go to bed, we are surrounded by commodities. The coffee we drink and the sugar we sweeten it with are commodities, so too are the steel that holds our cars together, the oil that makes them run, and the natural gas that heats our homes.

Nothing about commodities is bush-league; in 2009, the production value of seven of the most important commodities was north of $3.6 trillion. The value of the commodities traded on the world's futures exchanges dwarfs the dollar volume of transactions on U.S. stock exchanges. Commodities and the exchanges that set prices and marry up buyers and sellers of these crucial raw materials are so important to our way of life that the world as we know it just wouldn't be possible without them.

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Plenty of experts will espouse the merits of stocks, the benefits of bonds, and the advantages of real estate. But when it comes to commodities, there isn't much of a fan club, despite compelling evidence that when stocks and bonds are going down, commodities are usually going up. When inflation is heading higher and bonds and stocks are heading lower, commodity prices will be on fire. Commodities have been proven to boost returns and chop risk in an investment portfolio, but even sophisticated investors give them short shrift. For most investors, commodities just don't figure.

Trading Places

Commodities trade on commodity exchanges, where they are bought and sold for *future* delivery. The first commodity futures trading can be traced back to 17th century Japan, where farmers sold rice to local merchants who stored it year-round. Not content to just sit on their inventory of rice, the merchants raised cash to pay for their costs by selling "rice tickets," which were receipts against the stored rice. Over time, the rice tickets became accepted as a form of currency and rules were established to manage their trade.

Almost 200 years later, in 1848, a group of Chicago businessmen formed the Chicago Board of Trade (CBOT), a member-owned organization that offered a centralized place for trading a wide range of goods. With its convenient location between Midwestern producers and the east coast market, Chicago was a natural hub for cash trading in commodities.

As time went on, buyers and sellers negotiated directly with one another to sell crops at an agreed upon price not only on that day, but also on a *future* date. These negotiated transactions, known as "forward contracts," are still a fixture in the world of commodities. As trading in forward contracts increased, the CBOT decided that most details could be standardized to streamline the delivery and trading of the contracts. Under this new system, price and delivery date would be the only variables.

The standardized contracts the CBOT ushered in were America's first futures contracts. All bids, offers, and transactions were published by the exchange, which increased the transparency and popularity of these marketplaces. With standardized contracts, it was easy to trade commodities. Investors who wanted to profit from a drought in the Midwest could easily use the exchange to buy futures contracts for wheat, and if their views changed, they could sell their contracts just as easily. Standardization was a boon to trading.

Commodity futures are standardized contracts that trade on commodity exchanges; price and quantity are the only variables.

Other futures exchanges quickly sprang up. The Chicago Butter and Egg Board, founded in 1898, later became known as the Chicago Mercantile Exchange. Kansas City, St. Louis, Memphis, and San Francisco all got into the act by forming their own commodity exchanges; yet today, Chicago still reigns supreme as the epicenter of U.S. futures trading. Globally, there are major commodity exchanges in more than 20 countries.

Yeah, But . . .

Commodities get a bad rap. In spite of their importance to the global economy, they are among the most misunderstood of all asset classes. Bonds, stocks, and real estate all have plenty of followers and universal agreement amongst experts regarding their importance within a well-diversified portfolio. But venture into the world of commodities, and you're into a fringe area of investing where understanding is limited and suspicions run deep.

In the 1983 movie *Trading Places*, Eddie Murphy and Dan Aykroyd team up to turn the tables on their former employers, Mortimer and Randolph Duke, by placing a winning bet on commodities. In a single trading session, Louis Winthorpe III (Aykroyd) and Billy Ray Valentine (Murphy) become fabulously wealthy while destroying the Dukes financially. To skeptics, reversals of fortune like that are all too common in the world of commodity investing, where volatility and complexity are the order of the day.

But peek behind the curtain, and most of the criticisms of commodities just don't hold water. While commodities are more volatile than bonds, their volatility is about the same as that of stocks. Commodities have no funky accounting, scandalous behavior by management, or incomprehensible off-balance-sheet items that can skewer your finances overnight. The problem with commodities—if there is one—is the amount of leverage investors can employ.

Leverage is a double-edged sword. It can boost your returns when prices are heading higher and tank your investments when prices are sinking. "Leverage," using other people's money, is quite common. For example, when you buy a house and take out a mortgage, you're using leverage. Both stocks and commodities can be bought on margin, but by law a stock buyer needs to pony up at least 50 percent of the purchase price. In commodity investing, margin requirements are skinnier—sometimes as little as 5 percent.

Suppose you decide to buy crude oil contracts when oil is trading at $50 per barrel because you think it's moving higher. You open a futures trading account, slap down the minimum margin of $5,000 per contract and—presto—you're instantly controlling $50,000 worth of crude oil ($50 per barrel times 1,000 barrels per futures contract). If oil moves from $50 per barrel to $55 per barrel, your position is worth $55,000 ($55 per barrel times 1,000 barrels) and you've doubled your money and are no doubt feeling pretty smart. But if oil goes from $50 to $45 per barrel, you've lost your whole investment. Still feeling so smart? I don't think so.

Wait a Minute

The Yale International Center for Finance, in their working paper *Facts and Fantasies About Commodity Futures*,* concluded that an unlevered basket of commodity futures gave as much bang for the buck as stocks. Not only did futures offer similar returns to stocks, but they tended to perform well when stocks and bonds were doing poorly. By adding futures to a well-diversified portfolio, the researchers found you could chop risk while boosting returns—a nifty trick. Because the value of commodities is tied to tangible assets, they performed well in inflationary periods, or times when prices were rising. Including commodities in your portfolio can not only help diversify it, but may also help you preserve wealth when inflation is gobbling away at the value of your stocks and bonds.

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* Gorton, Gary B, and K. Geert Rouwenhort, "Facts and Fantasies About Commodity Futures," Yale International Center for Finance, Yale ICF Working Paper No. 04-20, June 14, 2004.

In a separate study on commodity returns, Ibbotson Associates* found that adding commodities to an investment portfolio helped to reduce risk and increase diversification by generating superior returns when they were needed most. The researchers concluded that *all* portfolios could be improved by the addition of a healthy dollop of commodities.

Ricochet

Shell-shocked investors watched in horror as the commodity markets tumbled with the collapse of Lehman Brothers in September 2008. Executives at commodity-producing companies nearly went into cardiac arrest as their share prices cratered, forcing them to slash expenses just to keep their companies afloat—mines were closed, oil fields were capped, and steel mills slammed shut.

However, as the global economy picks itself up off the mat, the demand for commodities—the stuff that economic recoveries are made of—will soar. Commodity production is a time- and capital-intensive undertaking requiring extensive engineering, environmental, and permitting procedures before work can begin. Lead times for obtaining most major pieces of equipment are measured in years, not months. In addition, a severe shortage of

* Idzorek, Thomas M., "Strategic Asset Allocation and Commodities," Ibbotson Associates, March 27, 2006.

well-qualified people and investment capital means new sources of commodity supply will be a long time in coming. Sluggish supply and voracious demand have set the stage for our next bull market—one that won't be in North American real estate or blue chip stocks, but in commodities.

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A Bulging Middle

An exploding global middle class, fueled by global trade, is supplying the liquid hydrogen to the commodity rocket. Over the last 30 years, hundreds of millions of people have been lifted out of extreme poverty and transformed into global consumers. According to a recent World Bank report, between 1990 and 2002 some 1.2 billion people joined the ranks of the developing world's middle class. These people are not rich by Western standards, but are rich enough to leave a subsistence-level life behind and begin to spend. More remarkable, the report noted that four-fifths of this emerging middle class were from Asia and half were from China.

Others have predicted that the pace of this middle class expansion will accelerate, likely reaching its zenith around 2018. Goldman Sachs estimates that by 2030 a further two billion people could join the global middle class (defined as having a household income in the range of $6,000–$30,000). We may bemoan the decline of the American middle class, yet researchers at Goldman have found that the distribution of global income is becoming *more*, not *less*, equal, a trend that is likely to continue. The surge of the world's middle class is happening on an unprecedented scale. Affecting more than one-third of the world's population, the shift dwarfs the massive transformation of the global economy that occurred during the 19th century.

A mass migration is underway through much of Asia, as people leave the fields in search of better lives in the cities. With millions of new factory workers hitting the big cities, tremendous demand is being created for housing and other crucial infrastructure. This demand will underpin the boom in commodities as these new workers and their families begin to buy appliances, apartments, and cars. The last great bull market for commodities lasted from 1968 to 1982, when the Baby Boom generation was on a buying spree. But this time round, the scale of the economic transformation will eclipse anything we've seen before.

The key to understanding commodities is to understand China—a country that for 18 of the last 20 centuries has had the largest economy in the world. China is already the world's largest consumer of iron ore, copper, zinc, aluminum, nickel, and coking coal. It's also the second largest consumer of crude oil and the largest producer of steel—by a country mile. Not only is China growing at a furious clip, but so too are other emerging economies such as the Philippines, Vietnam, India, and Malaysia. Billions of people, all with aspirations like you and me, will demand the chance at a better life—and that's a good news story for commodities.

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A Decade of Decline

For investors in America's benchmark index, the S&P 500, the period from 2000 to 2009 ranks as the worst decade in nearly 200 years of American stock market history. Not even the 10 years encompassing the Great Depression was as dismal for U.S. investors as the one we have just witnessed. By the time 2009 drew to a close, the S&P 500 index finished the decade *24.1 percent below* where it had started—despite having two 50-percent-plus up moves. Investors would have been better off investing in almost *anything* other than the U.S. stock market. Stuffing their money under a mattress for safekeeping would have been a savvier move than investing in the S&P 500.

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The world witnessed a seismic shift in economic power during the first decade of the 21st century. The fastest growing economy in the Americas is no longer the United States, but rather, Brazil. Those who invested in the U.S. stock market at the height of America's power are poorer for the experience. First they suffered through the popping of the technology bubble and then the collapse of Wall Street. Global investors fared somewhat better but, because U.S. stocks account for almost one-third of world market capitalization, they too got caught in the downdraft. At the start of the 21st century, America's stock market capitalization was more than $15.1 trillion, but by the end of the decade it stood closer to $13.7 trillion. Over the same time period, the stock market capitalizations of both Brazil and China soared more than fivefold while India's stock market increased more than eightfold. And China, at the start of 2010, is set to overtake Japan as the world's second-largest economy.

Worse yet, America enters 2010 without a world-leading major industry. At the start of the past decade, America had two industries that were visible symbols of its economic preeminence: high tech and high finance. Both industries expanded rapidly, promising to enrich their employees, but instead they impoverished many. To promote their industries to investors, they relied on the notion that creativity was limitless and so too were profits. After all, American finance and technology appeared to be reshaping the world. America and its publicly listed companies benefited from the global perception that in all things that mattered most, America was simply the biggest and the best. But by the end of 2000, the technology boom that made so many people in California rich had quickly turned to rot. In the process, Silicon Valley became Death Valley, sinking the state's economic hopes and prospects.

After the tech wreck of 2000, Wall Street and the world of high finance stood alone as the engine for stock market growth. When the *Glass-Steagall Act*, which separated investment banking activities from commercial banking, was repealed, Wall Street's power and influence grew dramatically. Its dominance was reflected in its weight and overall importance in the S&P 500 stock index. By the end of 2007, the financial services sector accounted for 40 percent of all S&P 500 earnings—up sharply from its historical contribution of 15 percent.

Bond Blues

In the investment game, bonds are often characterized as the steady performers, great for cranking out solid investment returns but not as fleet of foot as sexy stocks. In spite of that reputation, over the last 25 years bond investors have had it good—they earned great returns and were exposed to very little risk. The golden era for bonds was the 25 years following the 1968–1982 commodity bull market.

The 1970s, on the other hand, were a great decade for commodities but not much else. Inflation was rampant, hitting 13.3 percent in August of 1979, and prompting a desperate President Jimmy Carter to appoint Paul Volcker to the post of chairman of the Federal Reserve. Only by ratcheting up the benchmark federal funds rate to a high of 20 percent in July 1981 was Volcker able to tame the inflation beast. In the ensuing decades interest rates were on a steady downward path, setting the stage for a massive bull market in bonds. When interest rates are falling, bond prices move higher, rewarding investors by giving them both capital gains and interest income. But can the party continue?

No. With interest rates on U.S. government bonds at multi-decade lows, there's nowhere for bond prices to go but down. Right now, central banks in the West are keeping interest rates artificially low in an attempt to breathe new life into their comatose economies, but eventually rates will have to rise to stave off inflation. And when interest rates rise, bonds fall.

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The House Is A-Rockin'

In 2000, a wave of new, more aggressive lending practices had taken root in the U.S. real estate market, which, when coupled with loose lending standards and an easy-money culture, helped propel U.S. house prices into the stratosphere. For the average American worker, long-conditioned to expect ever-rising levels of consumption, the rapid rise in residential real estate prices offered a simple solution to the dilemma of stagnant wages—their homes could be used to plug the gap. As house prices were rocketing ever higher, homeowners threw caution to the wind and turned their homes into ATMs to fund their lifestyle—and no wonder, as real wage growth was stagnant from 2000 to 2007.

But economic disaster struck as real estate prices in the U.S. have tumbled hard—down more than 30 percent from their 2006 peak. Since the credit bubble of 2008–2009 burst, average house prices are down more than 50 percent in some U.S. cities. While the American housing market has started to stabilize, it still faces significant headwinds. A stagnant economy, weak job market, and a persistently high foreclosure rate are all major obstacles to overcome. Since housing accounts for 20 percent of the U.S. economy, an improved outlook will be a key pillar of any economic recovery.

What Am I Missing?

Most of the West faces years of slow growth and sluggish economic prospects in the wake of the greatest market meltdown in a generation. The last decade has been unkind to most investors. Stocks have tumbled badly, the bond rally has stalled, and real estate has turned out to be a sucker's bet.

But there is an alternative to investing as you always have; you can open your mind to the world of commodities, to a world without a legion of followers but with plenty of upside. Driven by surging Asian markets, sluggish supply, a sagging U.S. dollar, and few, if any, investment alternatives, the next great commodity bull market is now upon us. What are you waiting for?

Hot Commodities

- Commodities are part of our everyday lives and crucial to modern existence.
- Commodity futures are standardized contracts that trade on commodity exchanges. Price and quantity are the only variables.
- When stocks and bonds are going down and inflation is heading higher, commodity prices move up.
- There are legions of followers of stocks, bonds, and real estate, but there isn't much of a fan club for commodities.
- China is the key to understanding commodity demand.

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- For investors in the S&P 500, 2000 to 2009 ranks as the worst decade in nearly 200 years of American stock market history.
- With interest rates on U.S. government bonds at multi-decade lows, there's nowhere for bond prices to go but down.
- Commodity returns are similar to those of equities, but commodity returns are not well correlated to those of stocks or bonds, making an ideal addition to most portfolios.
- If not commodities, then what?