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Why the bulls have got it all wrong with commodities

By Peter Tasker
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Di-worsification is what you do when you invest in mediocre assets for a mediocre reason - for example, because a statistical model has told you they reduce risk. Thanks to the boom in commodities during the past decade, these have become a favoured choice for di-worsifying institutions everywhere. The profusion of funds and exchange-traded funds, indices and brokerage coverage has made commodities unprecedentedly easy to access for individuals too. However, the long-term performance of commodities is pathetic, and there is little reason to believe that this time is different.

In Saul Bellow's 1956 novel *Seize the Day* , the hero is led to financial ruin by a dubious investment adviser who encourages him to take oversized positions in the Chicago commodities market. Bellow's timing was excellent. The CRB index peaked in 1956 and did not make a fresh high until 1972, when another intense bull market got under way. The great 1970s boom peaked in 1980, and this time highs were not seen again for 25 years.

The pattern of short booms followed by long slow declines is characteristic of commodities markets. The result is a miserably poor return on investment over the long haul. If Bellow's hero, Tommy Wilhelm, had held a position in the CRB index from 1956 until today, he would have lost 75 per cent of his capital in real terms. The idea that commodities are a good inflation hedge is absurd.

The noughties commodities boom began in 2001. If the 2008 peak is not breached, the bull market will have been somewhat shorter and weaker than the 1970s blow-off - seven years versus nine years - and a trough-to-peak gain of 150 per cent versus 250 per cent. But in the 1970s consumer price inflation was high. This time inflation has been subdued, meaning that in real terms the trough-to-peak rise in prices was roughly the same. If the commodity markets follow the same pattern as last time, we can expect to see a multi-decade bear market in which prices make a series of all-time lows in real terms.

Bulls would say market conditions have changed out of all recognition, that supply limitations are finally being reached, that fresh discoveries are in ever more remote and inaccessible locations, and that China's insatiable demand for raw materials constitutes a new demand factor. But all these explanations were equally valid 10 years ago when prices were much lower. The currently very high premium of selling prices to extraction costs - as revealed in the super-normal profit margins of the extractors - is the best possible incentive for exploration, also for substitution and conservation.

In reality the new drivers are not so new as they appear at first sight. Industrialisation did not start with China - the post-war reconstructions of Europe and Japan were also "unprecedented" in their time, and technologies such as offshore drilling and deep mining were revolutionary when they first appeared. Historically there has always been a substantial time-lag between rising prices and fresh supply - which is why commodity bull markets are so intense and bear markets so long lasting.

Commodities have not even done their job as risk reducers. During the credit crisis the commodities indices mimicked the gyrations of other risky assets, with the correlation to stock markets of individual commodities such as copper and oil rising to new highs. Unsurprisingly, given the inflows of hot money, commodities have become just another aspect of the global "risk-on/risk-off" trade.

Why have commodities been such a bad investment for so long? The simple answer is that commodities generate no income - as opposed to, for example, equities, which generate the bulk of their long-term return from the reinvestment of dividends. Worse, commodity investors have recently had to endure a negative roll as several of the more popular markets have been forced into contango. The result has been a significant underperformance of ETFs in particular versus the spot markets they are supposed to be tracking.

The complicated answer is that commodities don't deserve to generate any return. As the name suggests, they are undifferentiated lumps of naturally occurring materials. Value needs to be added to them by the application of knowledge; it is investment in that process of application that earns the return. Over the long haul the price of the commodities themselves reverts to the cost of production.

As societies become more sophisticated, knowledge generates ever greater returns. By contrast, societies in which commodities are highly valued are by definition primitive. That is why the price of copper peaked out in ancient Egyptian times, when a few kilogrammes could buy you a slave girl. Its purchasing power has been in decline ever since. In essence copper has been in a bear market for 3,000 years. Consider that before you di-worsify.

The author is a Tokyo-based analyst with Arcus Research