

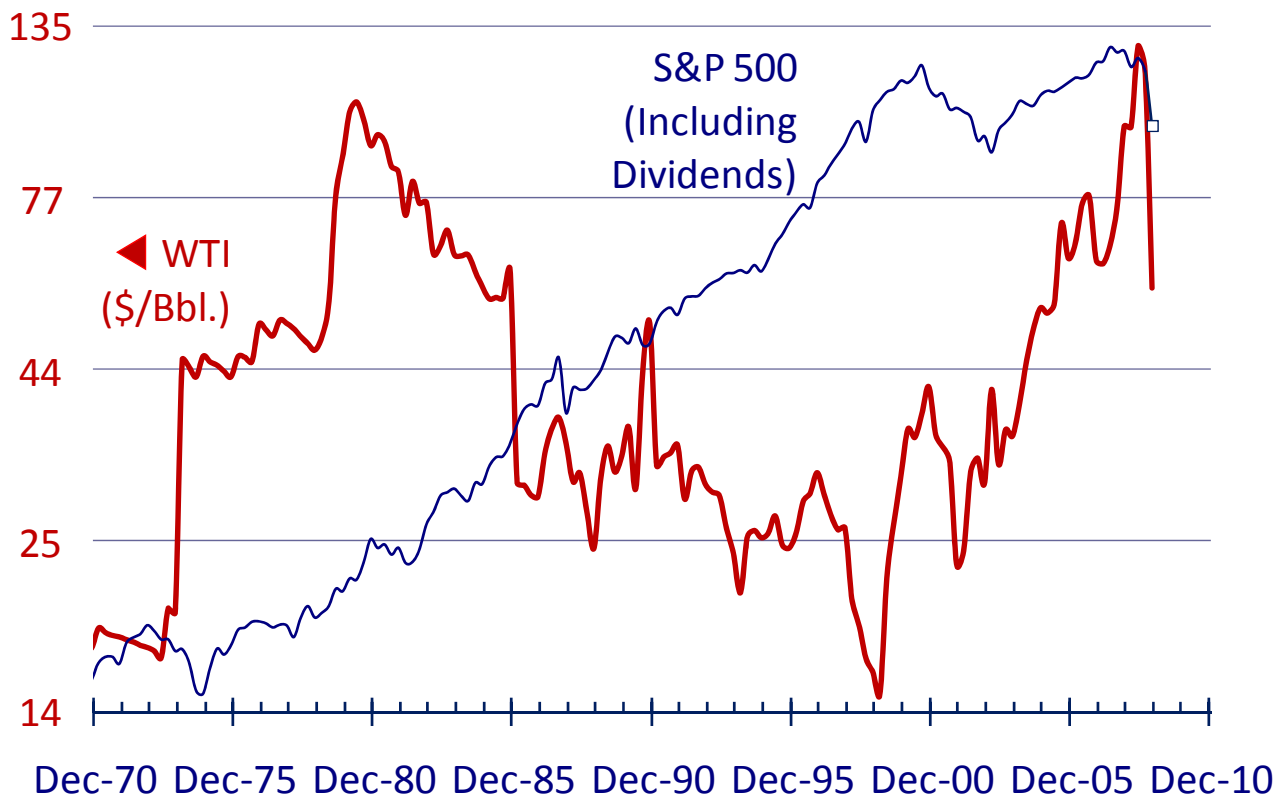
Still a Place in Our Portfolios for Commodities

- One of the most severe sell-offs of 2008 has been in the commodities market. A benchmark barrel of crude petroleum (West Texas Intermediate or WTI) now trades -60% lower than the July high, and a broad range of other commodities – including energy, industrial and agricultural products – have suffered similar drops. Likewise, the cost of shipping has plummeted, as the pace of economic activity and the value of cargoes have declined.
- Is commodity investing dead? We don't agree – we continue to believe there is a place for this asset class in the long-term, strategic allocation (or policy mix) of investors' portfolios. Our team made a tactical reduction in exposure to commodities near the peak of euphoria back in July (Please refer to the July 14 issue of "The Week"), and some clients' portfolios have benefited from that timely shift.
- Given the magnitude of the decline in commodities and the tremendous shift in sentiment, we no longer believe investors should maintain a meaningful underweight position relative to normal. We doubt that boosting commodity exposure today will be seen as clever in the short-term as the suggestion to reduce exposure in July, but we believe the near-term risks of further declines are now potentially offset by longer-term investment considerations.
- Extensive research published in the past decade by several authors -- e.g., Anson (1999), Greer (various dates) and Gorton/Rouwenhorst (2004) – indicates that diversified commodity portfolios have provided long-term returns of roughly the same magnitude as common stocks but with little correlation to other major asset classes like stocks and bonds. Of course, this research is based on historical performance, which is never a guarantee of future results. In fact, some are disappointed that the lack of historical correlation has not worked to investors' benefit in 2008; instead, the sharp decline in stocks and risky bonds this year has been mirrored in the commodities market. The Standard & Poor's GSCI Commodity Index (SPGSCI) is recognized as one of the leading measures of general commodity price movements and inflation in the world economy and has fallen -59% since July 3, making it easily the largest and steepest decline in its nearly 40-year history.
- What happened? In our view, commodities became too easily accessible for a wide range of investors and speculators; this may have contributed to a faster and more furious rise to the July highs than might otherwise have occurred. How much of the ensuing decline is justified by the global economic slowdown, and how much is the result of unwinding of leveraged positions by momentum-oriented investors? It is unlikely we will ever know.
- When commodities declined sharply in 1997-1998, it was difficult for most investors to access this market. When *The Economist* declared the world "Awash in Oil" (WTI was \$12/barrel), and when the Bank of England auctioned off one-third of their gold reserves (at \$250 per ounce), only a few institutions were dedicating a portion of their portfolios to commodity baskets or less liquid investments like timberlands.
- Fast forward a decade, and there are a multitude of vehicles – including exchange-traded funds (ETF) – that offer access to institutional and retail investors interested in broad commodity indexes and subsets such as precious metals, energy and agricultural products. The popularity of these products underscores the arrival of commodities as an asset class earlier this decade, made possible by strong gains from the 1999 lows and research like we have noted here. Investors relying on this research should understand that these views are widely accepted.
- One new product is the SPDR Gold Trust, which holds \$20 billion worth of gold – a good deal more than many of the world's central banks – for the benefit of its shareholders. While the value of that hoard has declined since the peak in gold prices earlier this year, there has been only a slight decline in the amount of gold held by the trust. Thus it is difficult to determine what role, if any, that liquidation of speculative portfolios may be playing in the commodities sell-off over the past five months.

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Crude Oil at \$55/Bbl. Is Exerting Much Less Upward Pressure on Other Goods & Services



Note: Log scale. S&P 500 return includes reinvested dividends. Oil price is shown in 2008 dollars (i.e., relative to the CPI ex-energy index). Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment. Figures do not include commissions, fees or expenses which would have a negative impact on investment results. Dividends can be increased, decreased or totally eliminated at any time without notice. Source: Bloomberg, Bureau of Labor Statistics, Standard & Poor's, Wall Street Journal.

For long-term investors, the recent acceptance as an asset class and popularity of commodities suggest a cautious approach, and we suggest a smaller strategic allocation than would be indicated by their historical performance. One study performed in 2005 by a pension consultancy suggested the high historical returns and low correlation with traditional asset classes supported an allocation as high as 30%. Even though most considered that to be too aggressive, given the liquidity constraints and the prevalence of momentum investors in the space, commodities vaulted higher in 2007-2008 as some large pension funds adopted strategic allocations around 5%. We believe growth-oriented portfolios can benefit from the potential returns and diversification provided by commodities over time.

The chart shows the “real price” of WTI crude oil, as compared to all of the other non-energy related goods and services that comprise the Consumer Price index. The S&P 500 is shown for reference purposes. The chart shows that WTI traded only briefly above \$77/bbl. (in 2008 dollars), and we now know that each instance resulted in increasing use of alternatives, demand destruction, and ultimately recession. The recent Saudi suggestion that \$75 is a fair price may well reflect that experience. From 1985 until 2004, crude oil traded mostly in a range from \$25 to \$44, so today’s price near \$55 may still be exerting some upward pressure on the remainder of the consumer basket.

For investors, the key question remains how to maintain or hopefully to increase purchasing power over time. Unfortunately, most traditional asset classes – like domestic stocks and bonds – have not proven up to the task when inflation expectations are rising. Thus, there has been an increasing emphasis on alternatives like commodities, inflation protected securities, etc. Many of these areas have suffered as the market turmoil has interrupted the trend of global economic growth. But the resulting responses by monetary and fiscal policy makers -- to inject liquidity and to stimulate additional spending – may provoke now-dormant inflationary fears and should, in our view, ultimately result in an economic recovery that would favor a renewed trend of demand for basic commodities.

Tom McManus

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Buying commodity based investments allow for a source of diversification for those sophisticated persons who wish to add commodities to their portfolios and who are prepared to assume the risks inherent in these markets. Any investment represents a transaction in a non-income-producing commodity and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.

Additional Information Available Upon Request

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