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A High-Risk Diet For Investors

Why a portfolio full of commodities may not be the best hedge against inflation

BY AARON PRESSMAN

THE COMMODITIES MARKETS are booming. The Dow Jones AIG Commodity Index has gained 18% over the past year (chart). Oil and copper prices are at all-time highs, while gold and silver are at 20-year peaks. Investors will add roughly \$30 billion to commodity index funds this year, estimates Barclays Capital, about what they put in U.S. domestic stock funds in 2005.

Wall Street firms, of course, flog trends like this for all they're worth. They have recently launched a slew of financial products, from exchange-traded funds that track the prices of gold and oil to mini futures contracts that don't require big sums of capital to get in.

The Street's marketing machine is pitching the products to two kinds of investors: momentum traders, and more conservative investors looking to diversify their portfolios with alternative assets and to protect against inflation. Both groups might be in for disappointment.

The conventional wisdom holds that because commodities are physical assets, they're the best way to hedge against rising prices, which eat into the real returns of purely financial instruments such as stocks and bonds.

Trouble is, the conventional wisdom seems to be wrong. Commodities have not kept up with inflation over the past 36 years, according to UBS Global Asset Management. And while it seems logical to assume that inflation



travels in tandem with commodity prices, the correlation is weak. Moves in the Goldman Sachs Commodity Index over three-year periods going back to the

1970s have swung from an almost perfect mirror of the consumer price index to the opposite. (A better way to hedge: Treasury inflation-protected securities, which guarantee a real return.)

There's more truth to the argument that diversifying a portfolio with commodities

increases returns. From 1969 to 2004, the Goldman Sachs Commodity Index gained 12.2% a year, beating the 11.2% return in the Standard & Poor's 500-stock index and walloping the 8.6% gain for bonds. A portfolio of half stocks and half commodities performed best, returning 12.5% a year with less volatility.

"FOOLED BY THE PAST"

BUT COMMODITIES are also highly cyclical, and they won't rally forever. "Don't be fooled by the past," says Campbell Harvey, a professor at Duke University's Fuqua School of Business and co-author of a paper examining commodity returns. "There's no... theoretical reason why these returns will continue."

Like most investment booms, this one will likely end up a victim of its own success. Commodity index funds don't buy gold bars or barrels of oil—they buy futures contracts traded on exchanges. Each month, as contracts expire, funds roll over their positions to new contracts. Peculiarities in the futures market have made those rollovers profitable in the past. Prices of longer-dated commodity contracts tend to be lower than shorter-dated ones, because there are usually more sellers eager to lock in future prices than buyers willing to speculate on them. As a result of this imbalance, commodities funds, buying lower and selling higher, have added about five percentage points a year to their returns over the past three decades, says Edwin Denson, an asset allocation analyst at UBS.

But now, with speculators piling in, the rollover opportunity is disappearing in many commodities. "That market inefficiency has gone away as it drew more attention," says Denson. Subtract five percentage points a year, and commodities wouldn't have beaten stocks or bonds.

The bulls say it's different this time. The market is being driven by fundamental forces such as demand from China and India and supply shortages stemming from decades of underinvestment. "Companies have been cutting back on exploration, development, and manpower since the 1980s," says Kevin Norrish, a director in the commodities research team at Barclays Capital. But such conditions have preceded other rallies, which have petered out when supplies caught up. This time, speculators who go all in might end up wishing they had spread their chips around the table. ■

