

## Red Flags Indicate Tailored Commodity Investing

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NEW YORK (HedgeWorld.com)—As institutions pour money into commodity indexes and commodity prices broach ever new highs, the B-word increasingly shows up at investment forums.

There are bubble characteristics at work, said Jeffrey Christian of CPM Group, a research and consulting firm, speaking at a New York Society of Security Analysts conference earlier this year. But he doesn't expect a widespread slump. Probably some commodities are over-bought, but many prices will remain high by historical standards, he said. The moral of the analysis was not to stay out of commodity investing but rather to consider specific conditions in individual markets. Since 2002 it has been easy to take a shotgun approach to commodities and buy the whole sector, but now investors have to take a rifle approach, Mr. Christian said.

A study by Barry Feldman of Prism Analytics and Hilary Till of Premia Capital Management LLC raises another warning. Analyzing data for several agricultural commodities from 1950 to 2004, they find that passive long positions tend to lose value when near-dated futures contracts, reflecting the spot price, are cheaper than longer-dated contracts—a condition called contango. In recent months a number of commodities, including oil and wheat, have been in contango. In the past, commodity index funds made a positive rolling yield as a by-product of their routine operation—selling near-term contracts before they expire and buying longer-term contracts. But the yield has now turned negative.

Some people, like Ira Kawaller of Kawaller & Company LLC, Brooklyn, N.Y., have long argued against passive commodity investing. Their point is that futures incorporate expectations of price changes, so holding an index-determined portfolio makes money only when prices rise more than expected. That has indeed happened in the past several years, but those increases are short-term windfall gains that can't be expected to continue, according to this line of reasoning. "The long position is essentially a bet that inflationary expectations will consistently understate the inflation that actually arises," Mr. Kawaller argued in an email message. "If that's not a dumb bet, I don't know what is!" (Needless to say, he pursues an active strategy.)

But expectations may be mistaken in specific markets. And commodity indexes are not all the same in composition. In particular, there are differences between the two main indexes, Dow Jones-AIG and Goldman Sachs, that 90% of the money is following. For instance, Dow Jones-AIG limits exposure to any one sector or commodity while the Goldman Sachs index does not, according to Matthew Schwab of AIG Financial Products; he spoke at the New York Society of Security Analysts conference. This may be the time for tactical allocation rather than passive across-the-board exposure to commodities. One option for betting on specific markets is to use the new single-commodity sub-indexes Dow Jones-AIG recently introduced [Previous HedgeWorld Story](#).

A contrary view is that we're still at the early stage of a bull market in a commodity super-cycle of 30 to 35 years. In that case, assuming futures prices don't reflect the rest of the boom, investing in a broad commodity index would make sense. But there haven't been such long cycles since World War II, Mr. Christian said at the conference, pointing out that the current boom has already lasted longer than the two previous periods of sharp increases in the past 50 years. He calls the commodity super-cycle a "myth."

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