

## Commodities Investing: Expecting the Unexpected

**By Chidem Kurdas, New York Bureau Chief**

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*This is the third in a series of articles.*

NEW YORK (HedgeWorld.com)—Crude oil futures rose sharply immediately after Katrina hit the Gulf coast but then came down by more than 5%. Following hurricane damage to refineries, price pressure and scarcity concerns shifted to gasoline.

More notably, near-term oil contracts have been worth less than deferred contracts—in technical terms, the oil market is in contango, in contrast to its usual pattern. These developments were not anticipated, but very little is anticipated in energy and broadly in commodities. One thing you can expect is that markets will over-react to news, especially to dramatic events like hurricanes, says Ira Kawaller of Kawaller & Company LLC, Brooklyn, N.Y.

With time the reaction works itself out, but there is no predicting how long that will take and what new conditions will shape the next phase. There's no free lunch here, said Mr. Kawaller.

Given that the unexpected is bound to happen, what type of commodities investment offers the best defense? One approach is to buy a broad-based index and hold it. Many institutions have moved into commodities via that route.

Active vehicles, like managed futures funds, global macro funds, and long/short equity funds focused on commodities-related businesses, have diverse approaches with varying risks and returns. They're subject to different types of surprises and control the damage in different ways.

### **Contrasts**

London-based Wessex Asset Management Ltd. has a long/short natural resource fund that invests globally, mainly in mining companies that have robust capacity reserves. Australia and Canada have the largest shares in the portfolio now.

As always, stocks can fall, especially with profit taking in the short run, said Richard Dennis, co-manager of the fund with Wessex founders Tim Weir and Peter Chesterfield. There is a protective margin in that the firms are still cheaper than the global market.

People were skeptical last year but cash flow grew again, said Mr. Dennis. Although share prices have gone up, they could be even higher as indicated by these companies' substantial cash flows, he said.

Wessex keeps its investment process focused on the enduring issue of scarce supply, identifying a broad mix of mature companies with long-term reserves and small businesses with capacity to produce in the future. With this type of investment, in-depth research is the key.

Trend-following managed futures funds offer a contrasting alternative. The nice thing about a systematic, quantitative approach is that you can build unexpected events into the model so that it can digest hiccups, said Cengiz Belentepe of Corton Capital Management LLC in West Conshohocken, Pa., a commodity trading adviser.

If you look back in time, you find that many trend-following funds were able to manage nasty surprises, Mr. Belentepe said. After trading derivatives at Citigroup and getting experience in discretionary trading, he decided he preferred to codify insights in a formal model.

While the model is automated, an understanding of the relationships underpins it, he pointed out. Those relationships can be tested; when an event takes place, one can observe whether the consequences are as indicated by the model.

Which type of commodity-related investment is more appealing largely depends on what kind of risk the investor is willing to take. In an ideal world the hazards would be exactly calibrated to the investor's risk preference, but it is not easy to avoid the unexpected.

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