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WHY COMMODITY EQUITIES

Commodity related investments have once again become vogue. Investor interest in the sector has been spurred for a number of reasons, including low correlation to equities, protection against rising inflation/weakening currencies and participation in global growth – especially growth from the developing world. But commodity investments have too often proved to be a mirage – the illusion of growth in the desert of sub-par returns, high volatility and unexpected correlation.

One should select a vehicle for natural resource investing based on rationale and return expectations. However, in the natural resource sector, the available investment vehicles have traditionally defined the asset class, rather than the other way around, with vehicles designed to meet investor need. In practice this means that investors typically turn to futures to fill their “commodity” allocation. Most common are vehicles (mutual funds or ETFs) linked to commodity indices such as the Dow Jones-UBS (formerly Dow Jones-AIG) Commodity Index and the Goldman Sachs Commodity Index.

Investors have generally been disappointed with the performance of these indices. Despite the commodity boom that occurred from 2006 to the summer of 2008, and the sharp rebound after the March 2009 lows, commodity indices appear to have underperformed. The question is “underperformed what?” Funds that invest

in commodity futures have little tracking error to futures indices. However, there may be significant disparity between commodity futures returns and the movement in commodity spot prices. Technical factors such as the implied costs of storing physical commodities and transaction costs create some of the divergence.

The most important factor in the success of any futures based commodity investment (either actively managed or index) is due to a large extent on the term structure of the futures curve for that commodity. When the contract price to buy or sell a commodity in the future decreases as time to that contract’s expiration increases, a condition called backwardation occurs. When prices get higher as time to expiration increases, the condition is called contango. Generally speaking, backwardation is beneficial to futures investors, while contango is harmful. This is because at expiration, an investor who wishes to maintain the same economic position has to settle the expiring contract and buy a new one. If the market is in contango, the investor is forced to sell low and buy high. Therefore, the performance of commodity futures can underperform the performance of commodity spot prices, sometimes dramatically, as the table below shows.

Commodity equities also provide access to natural resources that do not have traded futures contracts. Investors use the word “commodity” to

TABLE 1: DIFFERENCE OF RETURN

	<u>2007</u>	<u>2008</u>	<u>2009 YTD</u>	<u>3 Year*</u>
Generic Oil Future (USO)	46.82	-56.31	9.34	-13.96
Oil Spot (CL1)	40.52	-38.64	28.53	-0.14
Oil & Gas Production Equities	35.83	-44.92	51.20	6.34

*Annualized

Source: Factset Aggregate Oil & Gas Production, Bloomberg

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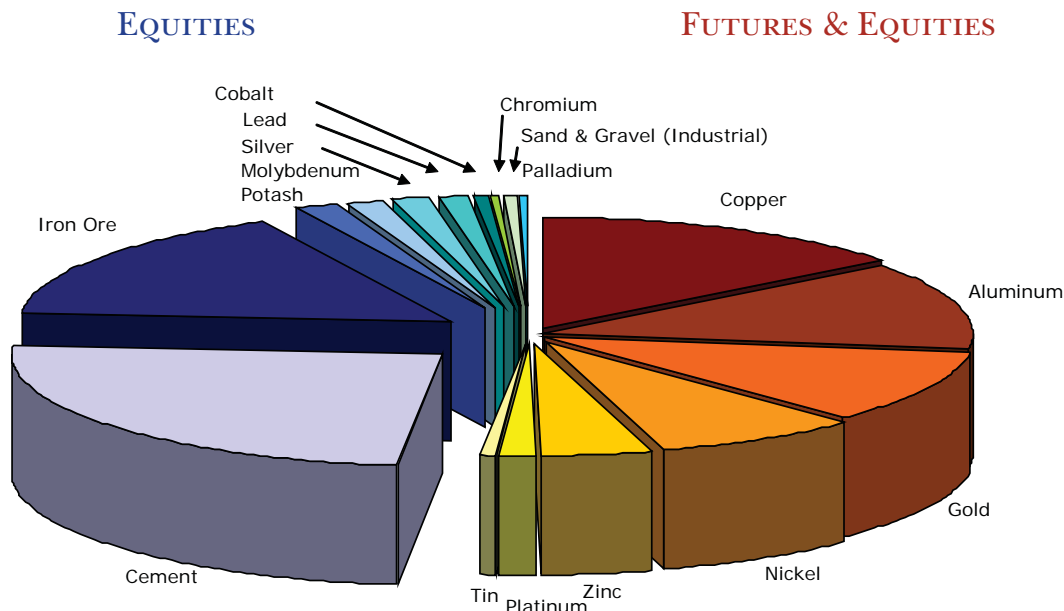
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refer both to the futures contracts as well as the underlying physical instruments. Yet most natural resources do not have related futures contracts, including highly abundant materials such as iron ore and coal and more rare but highly valued items such as uranium. The chart shows the difference between the broad universe of physical resources and those that are accessible via traded futures contracts.

time, since they need to buy commodities as an input to make more finished products.

How should investors use commodity equities as part of their asset allocation? Commodity equities represent a broadly diversified investment in global growth. They also represent an investment in the shift in the developing world from a source of supply to a source of demand for commodities. Perhaps most impor-

CHART 1: METALS UNIVERSE



Source: 2008 US Government Geological Survey based on 2007 Global production in USD

Commodity related equities also provide the ability to invest in servicing and related industry companies. These include equipment makers (i.e., mining equipment), service providers (i.e., contract drillers, commodity shippers), other raw inputs (i.e., fertilizers) and companies that transform raw materials into a usable product (i.e., oil refiners, smelting companies). The companies react differently to changes in underlying commodity prices, sometimes leading, sometimes lagging. Some, such as refining companies and utilities can be inversely correlated to the underlying commodities for some

tantly, natural resources equity investments do not require continued increase in underlying commodity prices in order to be profitable. Purchasing a commodity future is an explicit bet on rising prices. Investing in natural resource companies is a more nuanced, more diversified way of benefiting from supply/demand imbalances in the asset class. Equity resources investing broadens the universe to include a wide variety of natural resources and also the services, equipment and other inputs required for their extraction, refinement and ultimate consumption. ♦