

## WHY RAW MATERIALS?

By: Jim Rogers

Natural resources influence a significant portion of the world economy. They are the largest “non-financial” market in the world. Many studies indicate raw materials price movements are not correlated to the price movements of financial instruments. This means a natural resource investment can provide important portfolio diversification.

A recent study by Yale University’s School of Management and the Wharton School at the University of Pennsylvania demonstrated that commodities have outperformed stocks and bonds over a recent 45 year period with less risk, and were a better hedge against inflation.\* The study also showed that direct, passive, commodity futures investing would have outperformed three times better than investing in commodity stocks during the same period.

Throughout history, there have been bull markets in raw materials every 30-40 years. Supply and demand regularly get out of balance, leading to recurring periods of rising (and declining) prices. During the 1980’s and 1990’s, natural resources had been in a bear market for about 25 years (e.g. sugar peaked in 1973, oil in 1981, etc.). Declining markets attract little in the way of increased productive capacity, and this bear market was no different. Virtually no one built an offshore drilling rig, or opened a lead mine, or developed a sugar plantation during this period. Quite the opposite - productive equipment deteriorated, was cannibalized or scrapped while other capacity closed and/or depleted.

Demand continued to increase during this period of static and declining sources of supply. Prices declined because of inventory liquidation. The stockpiles built up because of the carry-over, hoarding mentality, and the Cold War have been liquidated leading to all-time low inventories on a stocks/consumption basis. For example, the percentage ratio of foodstuffs inventories to annual consumption reached records of about 35% in the 1980’s. The ratio is in the low teens now.

The desperate raw materials dumping by the Russians, at a time when Asia just stopped buying in the late 1990’s, caused lows in many commodities. These lows may last for years. We may see long term double and triple bottoms even if the world economy slows. Remember, the 1970’s saw tremendous rises in raw material prices, despite economic stagnation, as supply and demand corrected imbalances.

An occasional argument against natural resource prices ever rising again is “technology.” However, the world has had repeated dramatic breakthroughs throughout history, yet these breakthroughs have not prevented periodic, multi-year commodity bull markets. We have seen faster transportation, communication, and productive advancements before in railroads, steam ships, radio, telephone, electricity, planes, etc. None kept prices down forever.

The hydrocarbon industry of the 1960’s and 1970’s is a recent example. In the mid-1960’s, drilling below 5,000 feet or offshore was almost impossible. An explosion of technological advancements led to 25,000-foot wells and offshore development world wide. The Hughes diamond drill bit led to unthinkable drilling efficiency. Yet oil prices rose 1,500% in that fifteen year period.

The Rogers International Commodities Index (RICI) was designed to meet the need for consistent investing in a broad-based international vehicle. Thirty-five commodities are represented in the RICI. This gives it breadth just as the S & P 500 is broader than the Dow Jones Industrials. International commodities are represented, whereas most other indices are regional or U.S.-oriented. For example, other indices exclude rice, the staple food of a large percentage of the world. All commodities in the RICI are publicly traded on recognized exchanges to insure ease of tracking and verification. The RICI does not include non-traded items such as hides or tallow, which are included in other popular indices.

The RICI attempts to balance consumption patterns worldwide. One popular index has 19% in precious metals with only 6% in hydrocarbons - the same weighting it gives orange juice. Another recently had as much as 69% in hydrocarbons, with only 31% for everything else the world consumes. The RICI is designed to offer stability - partly because it is broadly based and consistent in composition. Other popular indices change dramatically every year, which does little for continuity or stability.

In short, raw materials should always be represented in any diversified portfolio. Stocks, bonds, cash, and real estate do not provide sufficient representation of the world’s economy, nor sufficient non-correlation to each other.

One of history’s recurring raw materials bear markets may have ended, as supply and demand became unbalanced due to economic shifts. Previous commodity bull markets averaged about 17 to 18 years in length and experienced very large percentage increases. The RICI was organized to meet a need in the financial spectrum currently not effectively covered. □

\*“Facts and Fantasies About Commodity Futures,” by Gary Gorton and K. Geert Rouwenhorst, Yale ICF Working Paper #04-20, June 14, 2004.