

### How Wall Street is Manufacturing Inflation

February 22, 2008

When we started paying more for a cup of coffee at Starbucks in October, little did we know that this dose of inflation may have been Wall Street's latest gift to Main Street. We're all aware of the financial industry's penchant for repackaging subprime mortgages, municipal bonds, and anything else that can generate an investment banking fee. These creations can serve useful purposes, but they often have unintended consequences. As commodity prices continue to defy the gravitational pull of an economic slowdown, it's time to take a closer look at Wall Street's latest products, vehicles designed to invest in commodities.

Financial instruments tied to hard assets are nothing new. Energy and metals producers have issued a handful of bonds whose coupon payments were linked to oil or gold prices. The Central Fund of Canada has offered gold bullion in a closed-end fund since 1961, and Salomon issued a traded oil trust in 1990.

However, in size and prevalence, nothing compares to the recent explosion of Exchange Traded Funds (ETFs) tied to commodities. ETFs are investment vehicles which trade like stocks but represent broader baskets of securities, originally equity indices. As the chart illustrates, ETF assets have been growing rapidly on a global basis since their introduction in 1993. A gold ETF was first introduced in November 2004, and commodity-linked ETFs have since participated in the industry's growth. That pioneer vehicle, the streetTRACKS Gold Shares (ticker: GLD), is now one of the 10 largest ETFs. There are now dozens of commodity ETFs, offering exposure to individual commodities, sectors, and broad indices. Structured notes, equity traded notes and even some open-end mutual funds further support this trend. What was once a portfolio oddity is now a commonplace purchase by individuals and money managers.

Several factors spurred the creation of these ETFs. Work by Goldman Sachs and academics repositioned commodities as an investment "asset class." The dismal bear market of 2000-2002 whet investor appetite for alternatives. The acceptance of ETFs as investment vehicles and a broad commodity rally converged to increase demand dramatically. The commodity bull market

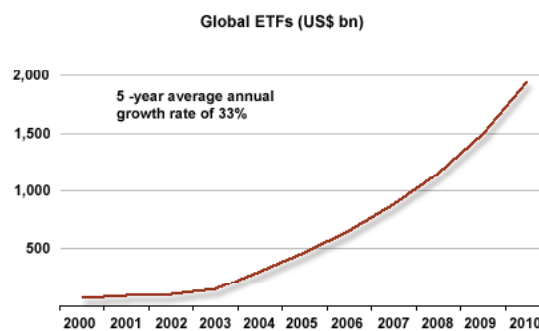
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Source: Investment Company Institute, Lipper Inc., and Celent Analysis and Forecast

was fueled by economic growth in developing countries, the fall of the U.S. dollar, the Iraq war, and government-supported ethanol demand. The good news is that in creating a vehicle that makes commodities look like stocks, Wall Street has made it easy for investors to participate in the rally. The bad news is that commodities are not stocks, and the differences hold some very important, real-world implications.

These ETFs offer a conduit from the financial markets to the commodity markets, but there is an enormous size discrepancy between the two. A small outflow from the financial markets represents an enormous inflow for commodities, with price-moving potential. Return to our Starbucks breakfast, the total global production of coffee in 2007 was worth about \$20 billion. Coffee is a 3% weight in the Dow Jones Commodity Index and a 0.67% weight in the S&P Goldman Sachs Index. Small weights to be sure, but it would not take much of a reallocation of the \$100 trillion in the global debt and equity markets to increase prices. To use a more concrete example, the World Gold Council publishes demand statistics for that precious metal. The primary component of demand for gold is for jewelry fabrication, led by purchases from India, China and the U.S. In 2006, the demand for gold purchased by ETFs and similar instruments exceeded all the jewelry demand from China. In 2007, ETF demand was just slightly below U.S. jewelry demand.

ETFs have turned investors and money managers, schooled in bond and stock markets, into commodity market participants. However, wealth creation markets (stocks), income generation markets (bonds), and risk transference markets (commodity futures) are different animals requiring different approaches. Traditional speculators in commodities are indifferent to being long or short (betting on either price increases, or price decreases). The new participants in commodity ETFs have a decidedly long bias; of the 205 million shares outstanding in the largest gold ETF, only 7 million shares are short, for example. In addition, unlike the sale of gold bullion, shorting a gold ETF does not directly release any gold into the market -- the investor may be short, but the ETF still holds the bullion long. Investors and fiduciaries who are treating commodities as an "asset class" and index their exposure, are also participating only on the long side of the market. This long bias means that the price pressure is only to the upside.

As if long-only strategies in commodities weren't inflationary enough, current investment styles may exacerbate the situation. Many quantitative investment strategies use momentum disciplines -- simplistically, buying stocks that are outperforming and selling them when they stop going up. With operating companies this may work -- after all, rising stock prices help attract and retain management talent, lower the cost of capital, and provide leverage for acquisitions -- legitimately resulting in even higher stock prices. Commodities are different. Every commodity rally sows the

seeds of its own destruction, as high prices prompt new production that ultimately drives prices down. This is all setting the stage for a potential “bubble” – buying at ever higher prices that make less and less sense.

The ramifications go beyond impacting individual investor portfolios. Undue inflationary pressures on commodities complicate the Fed’s job at a time when the economy is skirting with a recession. There is also an economic productivity issue in tying up physical commodities in storage or in “virtual warehousing” through the futures market. There is some concern that this activity is distorting traditional cash/future relationships. The National Grain and Feed Association recently stated, “the marketplace is ill-equipped to efficiently absorb more investment capital,” noting that these disruptions are increasing the costs to the producers and users, the very participants these markets were meant to serve. Finally, the consumer suffers through higher prices in end products.

The commodity exchanges have safeguards designed to prevent anyone from “cornering the market” using futures – but these were designed to protect against a single control entity in the manner of the Hunt brothers. The current pressures are coming from multiple sources. As it is, the Commodity Futures Trading Commission has proposed a rule change that would make the problem worse, allowing a “risk-management exemption” which would lift the existing constraints on this activity. The physical markets (cash or forward delivery) are also largely unregulated.

None of this is to suggest that commodity prices should not have risen in recent years. But, there is a question as to whether, under the influence of these new vehicles, we have gotten to the point where we are buying commodities simply because they’ve gone up. Is that really any different from buying tech stocks in the 90’s and real estate this decade?

So, when you drive away (gasoline) from the warm Starbucks (heating oil), having consumed your caffeine (coffee), juice (frozen concentrated OJ), and muffin (corn, wheat, sugar), know that you’ve frittered away an entire asset class. Before you call your stockbroker to replenish your commodity position with an ETF, you might think twice.

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