

# BARRON'S Online

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## Can-Do Commodities

*Despite a recent pullback, metals and other materials look strong for the long term*

By SUZANNE MCGEE

**STEVEN LEUTHOLD HAS BEEN** managing money -- his own and other people's -- for nearly four decades. During the runaway inflation of 25 years ago, he was among the millions of Americans who bought gold as a hedge. But even then, he never thought of himself as a commodities bull. "Commodities just weren't as interesting or attractive to us" as stocks and bonds, he says.

Today, however, Leuthold, who runs the money management arm of institutional brokerage Weeden & Co., holds a sizable position in metals. And it's not through futures contracts -- it's the real McCoy. Leuthold has amassed tens of millions of dollars' worth of ingots of silver, palladium, copper, aluminum and other metals -- and stored them all in his or his firm's name in metals warehouses across the country. He began buying last year, as metals prices began the most recent and most dramatic stage of a rally that took copper prices to a nine-year high of \$3,030 a ton and nickel prices from a low of \$4,000 a ton in 1993 to nearly \$18,000.

The strategy has caused him some headaches. A fire at one warehouse, for instance, scorched some of his aluminum. But one thing that has not troubled Leuthold has been the drop in commodities prices over the past couple of months. In fact, as hedge funds and other speculators dumped metals, fearing a cyclical downturn, Leuthold says he plowed "another chunk" of his own money into a private metals partnership he started last year.

He is just one of a growing number of investors who once scorned commodities as too risky but now find them nearly irresistible. These investors and a number of other experts figure that commodities are in the midst of a long-term bull market, perhaps the strongest in more than 25 years.

A central measure of the market, the Commodities Research Bureau index, is up 41% since January 2001, while the stock market, as gauged by the Standard & Poor's 500 index, has declined 3.3%. What's more, many bulls think commodities are likely remain strong for another 10 years or so, thanks to recovering world economies, surging demand from China and India and relatively low supplies across the commodities spectrum.

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Steven Leuthold has been buying metals and stashing them in warehouses.

prices in half, has doubled dividend yields on these stocks, he says, while price-earnings ratios are well below growth rates, often a sign of value.

At J.P. Morgan Chase's private bank, Chris Wolfe, head of equities, dismisses the selloff as short term, adding that now that speculators have fled the metals markets, "we're comfortable re-initiating positions."

The commodities market has always attracted more than its fair share of ardent supporters. But the new breed of commodities bulls is different and has added a measure of stability. Their ranks include Warren Buffett, who once publicly disparaged commodities stocks but whose holding company, **Berkshire Hathaway**, has become one of the biggest energy pipeline companies in the Western United States in the last two years, thanks to a buying spree of discounted assets in the wake of Enron's bankruptcy. Leveraged buyout firm Thomas H. Lee Partners is moving to acquire a majority stake in commodities trading firm Refco Group in a transaction that values Refco at about \$2.25 billion. Money management firms like Pimco and Oppenheimer that have made their names as stock and bond fund managers are now offering commodity-related mutual funds.

"I absolutely never would have thought of doing this a few years ago," says Jack Ablin, chief investment officer at Harris Private Bank in Chicago, discussing his decision to allocate 5% of client portfolios to commodities. "It sounded like a crazy idea."

Certainly, commodity market rallies over the last two decades have been limited, muted and brought to early, often ugly ends as demand faltered, new production flooded the market or rogue trading schemes



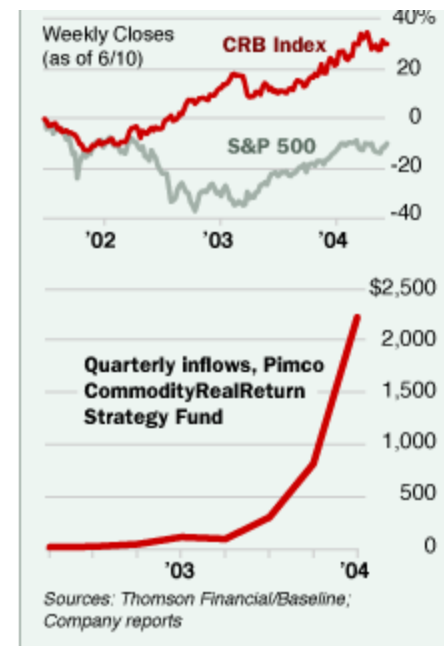
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Even this year's sometimes-brutal selloff in the prices of many key commodities hasn't shaken the confidence of commodities bulls. The problems -- chiefly signals from China that it would curb its own growth -- hit everything from metals to natural gas and soybeans. In all, the CRB index is off 4% since late March.

Many argue that selloff has merely set the stage for another leg in the long-term rally, as the market enjoys an unusual conjunction of acute capacity shortages and overheated demand of a magnitude not seen since the postwar recovery of Japan and Germany. Also helping: rising inflation around the world, a force that makes real assets more valuable compared to financial assets like stocks and bonds.

Of course, you don't have to fill a warehouse with metals to participate in commodities. Frank Holmes, chief investment officer of San Antonio-based US Global Investors, had accumulated a 20% cash position in the fund family's Global Resource Fund as of early April, but he has since invested nearly half of that in commodities-related stock like China's Jiangxi Copper and **Aluminum Corp. of China**.

This year's selloff, which cut stock



fell apart.

But there's good reason to think the rally of the past two years will prove longer lasting. Commodity producers, from farmers to miners, appear to have learned the tough lesson that boosting output in response to every upward price move doesn't just destroy the rally but threatens their own businesses.

Meanwhile, demand for most commodities is soaring -- simultaneously -- as developed economies recover from the recession and emerging economies, particularly China, display a hunger for raw materials to fuel their growth. As Chinese growth has soared to 9% a year, the large and growing gap between demand and supply has sparked intermittent shortages in key commodities and even in container-ship capacity.

Commodities bears, for their part, believe China may be just a fleeting phenomenon. They argue that the price gains will continue to evaporate as euphoria about China turns to acceptance of more moderate growth.

But China isn't the whole story. "Until 2001, central banks were trying to bring inflation a little bit lower at the end of each economic cycle," says Bill O'Grady, director of futures research at brokerage A.G. Edwards. In 2003, central banks came perilously close to going too far in the opposite direction and turning disinflation, or a decline in inflation, into deflation, an outright decline in price and far more terrifying to investors. "So now we're in an environment where the Fed would rather see some inflation than risk choking off growth and tipping into deflation," O'Grady says.

O'Grady argues that these circumstances have set the stage for a bull market that could last well into the next decade. The strength will change pricing patterns for most commodities, creating higher highs and higher lows over the life of the rally, he contends.

It is the China factor that has sparked much of the excitement surrounding commodities markets. China's demands for crude oil and coal have each soared 400% over the last decade and annual growth in demand for steel has topped 20% in each of the last three years, Holmes says. China now consumes 55% of the world's cement, he adds, as authorities try to fend off social and political instability by fostering economic growth and boosting living standards in rural areas.

"There is absolutely nothing normal about China's growth," says David Humphreys, the London-based chief economist of mining giant Rio Tinto Group; he predicts the Chinese impact on metals consumption could dwarf that of postwar Japan. China, Humphreys notes, "is not just another country, it is a fifth of the world's population."

But the China story, and its allure for speculators, reminds the bulls that the long-term rally they anticipate won't be free of bumpy cyclical peaks and valleys. The springtime selloff in metals markets, for instance, swiftly followed word from China that authorities wanted to curb growth and prevent the economy from overheating. So far, there has been little evidence that this has hurt real metals sales to China, say analysts, but that didn't stop speculators from fleeing and wreaking havoc on the market.

Such jolts can reward savvy trading. "This can't be a buy-and-hold investment strategy over the life of the cycle," says Tom McKissick, who manages \$4.4 billion in large-cap and concentrated value portfolios for Trust Company of the West, about 20% of which is invested in commodity-related stocks.

Even bulls argue that commodities shouldn't dominate a portfolio. Leuthold of Weeden has 6% of his \$500 million mutual fund in metals, while

John Brynjolfsson, manager of the \$4.24 billion **Pimco CommodityRealReturn Strategy Fund**, says that for most investors, a 5% allocation offers "plenty" of diversification and exposure.

The twin challenges for commodities bulls is deciding exactly what to buy and figuring out when it's time to leave the party. While some investors suggest buying index-linked products that offer exposure to an array of commodities, others urge targeting firepower where demand is most robust and supplies are most constrained.

Energy is a favorite for many. Environmental and geopolitical concerns have restricted new drilling and, says commodity economist Patricia Mohr at the Bank of Nova Scotia, accessible reserves are being depleted. "You will need to see sustained periods of much higher prices to spur new investment that will bring them on stream," she adds. Jay Sellick, senior analyst at 13D Research, an independent investment research firm based in Boca Raton, Fla., suggests investing in energy service stocks like **GlobalSantaFe Corp.** and **Weatherford International**.

Meanwhile, US Global Investors' Holmes trolls through Canadian and British stock markets in search of small mining companies that offer pure plays, such as **South African Resources**, whose cash flow is tied to platinum, and Canada's **Northern Orion Resources**, a gold and copper producer.

While more investors are piling into commodities, many take comfort that the market has yet to become truly mainstream.

"You worry when markets start looking like the stock market of the late 1990s, when everyone was convinced that trees could grow to the sky," says O'Grady of A.G. Edwards. "Today, it's more like the 1982 stock market, when no one believed that buying and holding stocks like Microsoft and Wal-Mart was the right strategy."

He pauses, then chuckles. "They lived to regret that, didn't they?"

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