

We applaud Jim Rogers for telling like it is concerning investing in commodities. The enlightening essay below goes a long way in killing the myths surrounding the commodities markets!

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The Daily Reckoning PRESENTS: Investors tend to steer clear of the commodities market, saying that it's just "too risky." But, as Jim Rogers points out, there has been more volatility in the NASDAQ in recent years than in any commodities index. Read on...

INVEST IN COMMODITIES - AND KEEP YOUR SHIRT by Jim Rogers

Recently, at a party in New York, I mentioned that I had been talking to various groups in the United States and Europe about investment opportunities in commodities. Before I could get out one more word, a woman interrupted me. "Commodities!" she exclaimed, with the kind of incredulity in her voice that Manhattanites reserve for people moving to Los Angeles. "But my brother invested in pork bellies and lost his shirt.

And he's an economist!"

Everyone seems to have a relative who took a beating in the commodities market, and this fact (or fiction) is considered sufficient reason that no sane person would ever risk playing around with such dangerous things.

That this particular victim was also a professional economist makes the warning seem even more ominous. I, however, couldn't help laughing.

Billions of dollars are invested in commodities every day. Without the commodity futures markets, many of the things that you depend on in life, from that first cup of coffee in the morning to the aluminum in your storm door to the wool in your new suit, would be either scarce or nonexistent, and certainly more expensive.

To be sure, investing in anything has its risks. A lot of Ph.D.s in economics lost money in the dot-com debacle, too. (On New Year's Day in 2002, the Wall Street Journal published its annual survey of economists for the upcoming year. Although the economy had been sagging for almost a year, not one of the 55 economists thought that it was in for a serious decline. One hundred percent were wrong - and proof that Ph.D. economists are as prone to mob psychology as the rest of us.)

There are several other bromides out there for why "ordinary people" should not invest in commodities, and I want to lay these myths to rest, once and for all, so that we can get on with the more interesting business of how you can begin to make some money investing in the next-generation asset class.

About That Relative of Yours Who Got Wiped Out - He was inexperienced. You can learn. Most likely, he was buying on thin margin - the minimum deposit a broker requires to take a position in a particular commodity - and when the market went against him he lost big-time.

Here's how it happens: Like stocks, commodities can be bought on margin.

Unlike stocks, however, where by law you have to put up at least 50 percent of the price of the shares, the margins on commodities can be even lower than 5 percent: You can buy \$100 worth of soybeans for \$5. If soybeans go up to \$105, you've doubled your money. Beautiful. But if soybeans go down \$5, you're wiped out. Not so beautiful.

Experienced, smart speculators can make tons of money buying on margin. They also know that they can lose tons, too. But they can usually afford it. Your relative was in over his head. If he had bought \$100 worth of soybeans in the same way that he can buy IBM - for \$100 (or maybe even \$50) - he would be happy when it goes up \$5 and a lot less sad should it go down \$5.

"But What About Technology?"

Whenever I mention commodities in public, someone always points out that we now live in a high-tech world where natural resources will never be as valuable as they were when we had a smokestack economy. But if you read your history you'll discover that technological advances are as old as history itself: The introduction of the sleek and beautiful Yankee clipper ship dazzled the world in the mid-nineteenth century, loaded with cargo, sailing down the trade winds at 20 knots and more, averaging more than 400 miles in 24 hours and able to make it from U.S. ports around Cape Horn to Hong Kong in 80 days; within a decade, the clippers had been replaced by the steamship, no faster but not dependent on wind power; and before long the next big thing in transport had taken over, the railroad, which, of course, was the original Internet - and prices in commodities still went up.

In the twentieth century came electricity, the telephone, and radio (three more Internets) and then television (a fourth Internet). There was also the automobile, the airplane, the semiconductor - and in the midst of all of these truly revolutionary technological breakthroughs came periodic, multiyear commodity bull markets.

Even a revolutionary technological breakthrough in a particular commodity-related industry will not necessarily lower prices. For decades, drilling below 5,000 feet or offshore was virtually impossible. Then in the 1960s the Hughes diamond drill bit was invented and an explosion of technological advances in oil drilling and exploration followed. Drilling efficiency - and oil deposits - were available that had been unthinkable before this technological breakthrough. Soon there were wells 25,000 feet deep and offshore oilrigs multiplied around the world. Yet oil prices went up more than 1,000 percent in the 15-year period between 1965 and 1980.

When the supply and demand in raw materials is seriously out of whack, the emergence of new technology will not necessarily restore the balance quickly. To be sure, changes in technology, for example, have made the economy less dependent on oil. But we still use plenty of it, and whenever there isn't enough prices will rise. Computers or robots may do amazing things, but they cannot find oil or copper where there is none or make sugar, cotton, coffee, or livestock grow faster than nature allows. We can put in orders all day long on our computers for

lead, but all that Internet technology will be in vain if there are no new lead mines.

Technology can neither feed us nor keep us warm, and the demand for commodities will never disappear.

"But Isn't It Only Speculation and the Lower Dollar That Are Inflating Prices?"

Certainly, speculators who jump in and out of commodities can push up prices. And the dollar has been a pale remnant of itself - down against the euro almost 40 percent from the beginning of 2002 until the start of

2004 and at a three-year low against the Japanese yen. Since commodities are traded in dollars, a weak dollar will make prices appear higher. Crude oil rose 64 percent in dollars over that two-year period, but only 16 percent in euros.

But the dollar strengthened in the spring of 2004, and a funny thing happened: Commodity prices kept going up. The global recovery, particularly in Asia, was for real. We are now watching a fundamental structural shift in commodities markets, and it is called "supply" - and "China," a nation that will be consuming extraordinary supplies of all kinds of commodities for years to come. I will explain why in more detail in a later chapter. For now, however, here's the story: dwindling supplies and increasing demand.

And the dollar has nothing to do with either. Let me also re-mind you of the 1970s, when inflation in the U.S. was about 10 percent a year, the dollar wasn't buying anywhere near what it used to, and the economy was in a major recession - and commodity prices kept rising. We're talking another long-term bull market in commodities, and neither speculators nor a weak dollar can make that happen. Speculators can have a short-term effect only. For example, if they drive up the price of oil artificially, oil producers with excess supplies will gleefully dump their oil on the market driving the price back down. Both the dollar and speculation can have a marginal effect, but the market itself is bigger than they are.

"But My Stock Broker Tells Me That Investing in Commodities Is Risky."

Tell me again about all those Cisco shares you owned back in 2000. Or JDS Uniphase, or Global Crossing? So many risky stocks made the turning of the new millennium a not so happy time for many, who watched their portfolios evaporate.

If you do your homework and remain rational and responsible, you can invest in commodities with perhaps less risk than playing the stock market. You don't need me to emphasize that investing in anything is a risky business. But let me point out something that you might not have realized: There has been more volatility in the NASDAQ in recent years than in any commodities index. Cisco, Yahoo!, and even Microsoft have been much more volatile than soybeans, sugar, or metals. Compared with the risk record of most tech stocks, commodities look safe enough to be part of any organization's "widows and orphans fund."

According to "Facts and Fantasies About Commodity Futures," the Yale study cited in the first chapter, the "high risk" of investing in commodities does not square with the facts. Comparing returns for

stocks, commodities, and bonds between 1959 and 2004, the authors found that the average annual return on their commodities index "has been comparable to the return on the SP500." The returns from commodities and the S&P 500 beat those from corporate bonds during that same period. They found that the volatility of the commodities futures under analysis was slightly below that of the stock in the S&P 500. They also found evidence that "equities have more downside risk relative to commodities."

How about buying shares in commodity-producing companies instead of buying commodities themselves? That's about as far as some financial advisers will go in the direction of commodities. But investing in commodity-producing companies can turn out to be an even riskier bet than sticking with buying the things outright. Supply and demand will move the price of copper, for instance, while the share prices of Phelps Dodge, the world's largest publicly traded copper company, can depend on such less predictable factors as the overall condition of the stock market, the company's balance sheet, its executive team, labor problems, environmental issues, and so on. Oil skyrocketed in the 1970s, but some oil stocks did not do that well. The Yale study found that investing in commodities companies is not necessarily a substitute for commodities futures. The authors found that from 1962 to 2003, "the cumulative performance of futures has been triple the cumulative performance of 'matching' equities."

And let me remind you of one more important difference between commodities and stocks: Commodities cannot go to zero, while shares in Enron can (and did).

Regards,

Jim Rogers  
for The Daily Reckoning

Past performance is not necessarily indicative of future results. The risk of loss exists in futures trading.