

FEBRUARY 2010

Commodities are likely to be one of the best performing asset classes over the next ten years, but they are also likely to be one of the most volatile. The global economy is entering the 'tens' with high debt levels, both at the private and public level. Governments facing a debt problem may decide that a little inflation is helpful in effectively devaluing the debt they have issued. If this happens, specific commodities have the potential to perform strongly.

Investment markets appear to have forgotten that man, despite his many accomplishments, owes his existence to a six-inch layer of topsoil and the fact that it rains. For thirty five years agricultural prices have declined, after adjusting for inflation. Little wonder New Zealand has slumped from the 3rd wealthiest nation in the OECD, as measured by income per capita, to 22nd.

Despite the long decline in agricultural prices, the world's population has continued to grow at 1.5% per annum. Growth in emerging economies is leading to the loss of agricultural land due to water shortages and urbanisation. But more significantly, a move to protein-rich diets requires significantly more agricultural output. A kilogram of meat requires feeding animals somewhere between three and five of grain or rice.

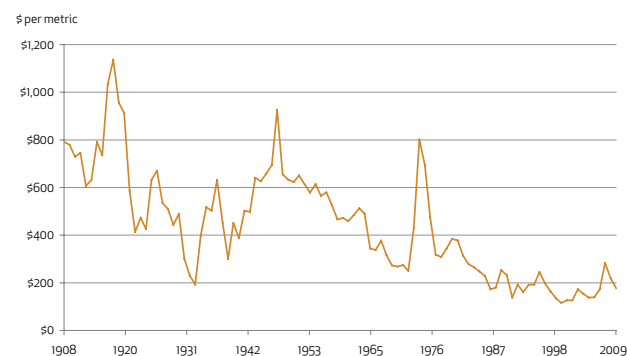
In eight of the nine most recent years, the world has consumed more grain than it has produced. As a result, global inventories of grain have fallen to levels marginally above those during World War II. Economic behaviour is conditioned by pricing, meaning that the economy as a whole will not allocate more resources to a sector unless the price or rewards for doing so are increasing. Given the multitude of competing options for capital in today's global economy, agricultural prices will need to revisit their all-time highs to ensure production keeps pace with rising global demand.

With the economic outlook still murky, investment in agriculture provides exposure to an industry that follows a very different cycle to the broader global economy. This makes agricultural commodities more defensive than industrial-driven alternatives such as copper and oil and the companies which produce them. Despite being an agriculturally dominated nation, New Zealand's investment markets offer relatively few opportunities for investors seeking to participate in rising agricultural prices.

Investors can gain a diversified exposure to agricultural commodities by buying an exchange-traded fund that for a nominal fee passively tracks the performance of wheat, corn, sugar, soy, coffee, cocoa and related agricultural commodities.

Those investors enamoured with China may wish to consider agricultural commodities as an alternative to purchasing Chinese shares. The Chinese share market is now trading at similar prices to internet shares during 1999 and 2000. Such valuations leave investors with little margin for error. Interestingly, China has 22% of the world's population but only 7% of its arable land and 8% of its water. If its economy continues to grow, then judging by the dietary shifts witnessed during other countries' industrialisation, the demand for agricultural commodities will explode, rewarding New Zealand's OECD ranking and investors in agriculture.

### WHEAT PRICE ADJUSTED FOR INFLATION



Source: United States Department of Agriculture, Economic Research Service.

New Zealand Funds Management's range of Growth strategies provide clients' with a diversified range of assets which have been specifically chosen for ability to deliver capital gains over time. These investments are selected and managed using New Zealand Funds' proprietary A.R.M.O.R investment process. Over the past seven years the Wealth Appreciation strategy, which includes investments in global shares and agricultural commodities, has returned an average of 11.29% per annum after fees as at 31 December 2009.

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