Market Commentary

NZFUNDS

COMMODITIES: THE ASSET CLASS FOR THE TENS?

FEBRUARY 2010

The past ten years have resulted in relatively mediocre returns for investors. Global shares have recorded the worst decade on record, returning a negative 0.7% pa, even worse than the 1930s. So what is the outlook for the next decade? Will shares perform better, or will another asset class outperform?

Over time, asset class returns tend to 'mean revert'. This means that if an asset class experiences a period of underperformance, then at some point it will experience a period of outperformance. Historically shares have returned around 9% pa, suggesting they may be due for a period of outperformance. But underperformance in the noughties might simply reflect their outperformance in the nineties.

Asset class	Decade performance (1999 - 2009)
Cash	6.27%pa
NZ shares	6.19%pa
Global shares	-0.73%pa
NZ government bonds	6.83%pa
NZ listed property	7.18%pa
Commodities	5.03%pa

Source: Bloomberg.

The global economy is entering the 'tens' with high debt levels both at the private and public level. These debt levels are likely to constrain investment and consequently economic growth. Similarly, inflation is now a bigger risk for investors than it has been over the past decade. Governments facing a debt problem may decide that a little inflation is helpful in effectively devaluing the debt it has issued.

Real assets such as property and commodities tend to outperform in a high inflationary environment. However this time residential property is entering the decade expensive, which is likely to constrain performance over the next decade.

Commodities are entering the decade reasonably cheap having underperformed in the '80s and '90s. They are as relevant in today's climate conscious society as they were in the smokestack industries of yesteryear. For example, hybrid electric cars require on average twice as much copper as conventional petrol cars, while lithium will become a key commodity as it is used in the manufacture of light weight batteries.

The economic recession has arguably improved the outlook for commodities as planned new investment to bring on additional supply of commodities has been postponed. This means that demand could easily outpace supply in the short term, resulting in higher commodity prices.

But investing in commodities is a high risk strategy. Commodities are one of the most volatile asset classes to invest in because supply is fixed in the short term. Any change in demand has to be reflected in a change in price.

In 2008 oil lost more than two thirds of its value as it declined from over $US145 barrel to under $US50 barrel in little more than six months. So while commodities are an important asset class, they should be held as a portion of a diversified portfolio. The outlook for commodities is positive over the next ten years but we are still likely to see significant price swings. These swings are likely to be too violent for the average investor to stomach.

Also, diversification alone is not enough to mitigate the volatility of commodities. The allocation to commodities should be actively managed. At some point over the next ten years investors will not want to hold commodities. For example, China is currently the largest importer of commodities. If their economic growth slows then prices could decline sharply.

If inflation is higher over the next ten years then investors will be thankful if they have an allocation to commodities. But the outlook is not one way, an actively managed allocation strategy should not only outperform over time but also reduce the inevitable price swings that cause so much distress to investors.

Asset classes can take 20 years or longer to 'mean revert', so when making decade projections simply picking the previous underperformer is not necessarily the answer. Shares have experienced 20 years of underperformance or even longer, so a new decade may not signal a renaissance for them. However, mathematically each decade that goes by with poor returns (and there can be two decades back to back) increases the probability of a decade of very strong share returns. Investors only need one ten-year period of strong returns to make three to four times their money, thereby enjoying a much higher standard of living in their retirement. The key is to not be financially dependent on the returns from any one asset class.

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