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# Commentary

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## Who Are The Commodity Speculators?

The following will appear in the May Edition of *Asia Asset Management* and is an expanded version of our April 28 **Market Facts** on Commodity Index Trading

*"Farming has always been a risky business, at the mercy of bad weather, wars and drought. Now farmers' profits face a new and surprising enemy: speculators who some believe are driving prices up so fast that growers are getting locked out of top dollar for their crops."* - **Associated Press, April 26**

With commodity prices skyrocketing, the need to place blame on one group or another for the rising cost of food has become a favorite game of the media as of late. All too often the "speculators" in these particular markets bear the burden of being the evil group responsible.

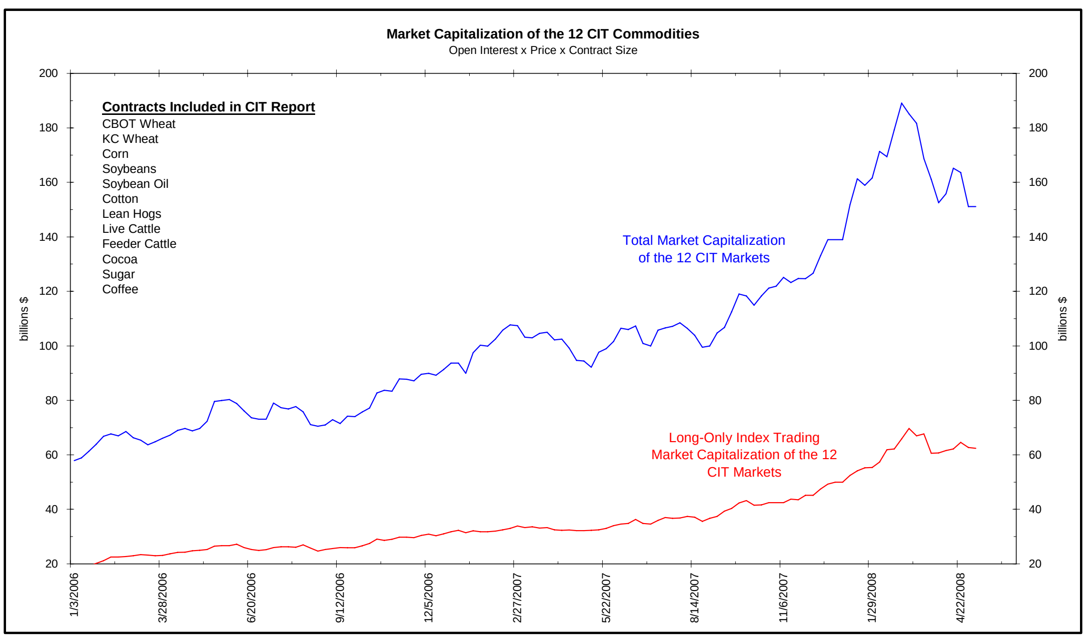
However, speculation comes in many forms. So while we all paint the mental image of speculator as a thirty-something impatient rapid-fire hedge fund trader, in actuality the dominant speculator in the commodities markets today might look more like ... you.

A relatively new report from the Commodity Futures Trading Commission (CFTC) shows that a new investment scheme popular among many traditional institutional mangers might be the real culprit behind the rampant speculation in commodities; **the long-only commodity index fund.**

Long-only commodity index funds are what the name implies. These funds seek to replicate commodity indexes by holding long futures contracts in the commodities that make up an index. As these contracts get close to expiration, they sell them, or "roll" into a more distant contract.

### The CIT Report

In early 2007 the CFTC began releasing a new supplemental report on commodity index traders (CIT). It provides the net futures and options positions of hedgers, speculators, and index traders for only the 12 agricultural commodity markets listed in the chart below. The data starts in the beginning of 2006.

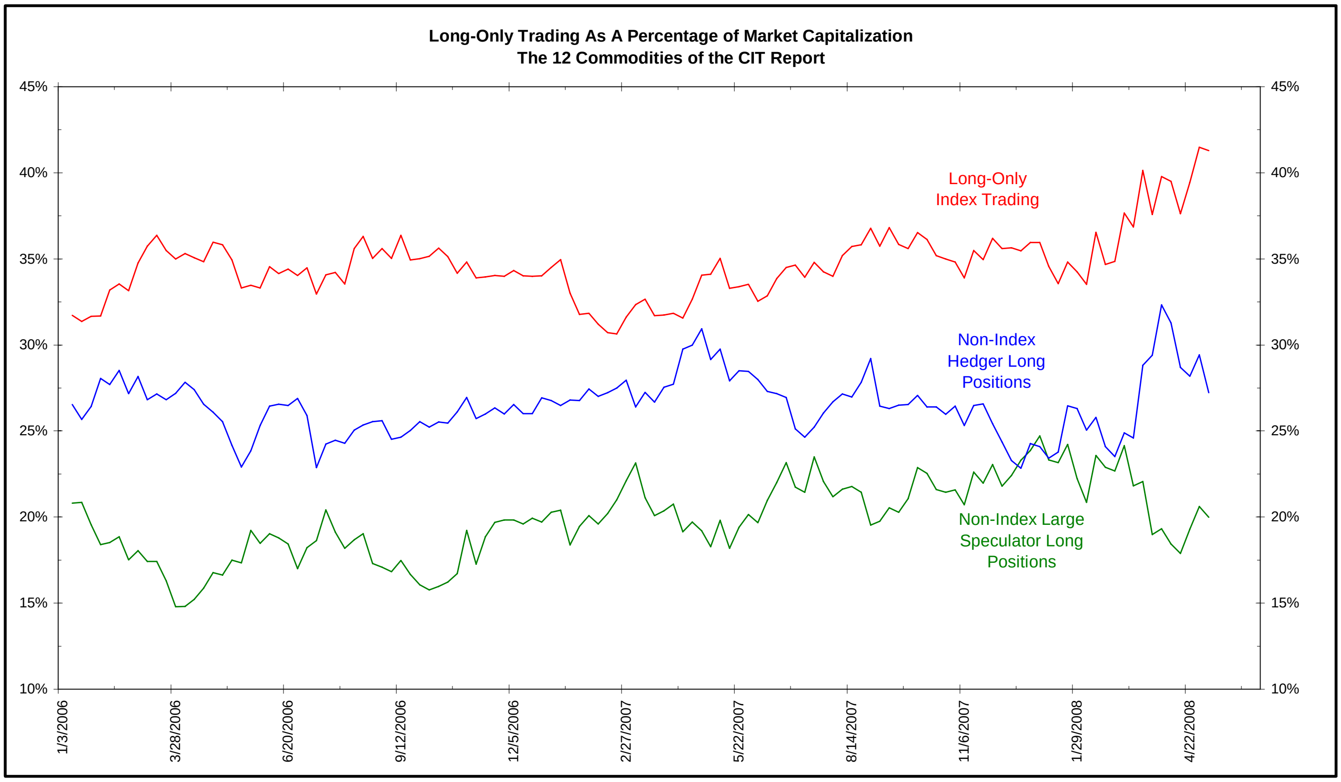


Although the CIT report does not include any of the bigger commodity markets such as gold or the various energy futures, we can still use this data to measure the size of the long-only commodity index funds. (For more on long-only index funds in crude **oil**, see our recent **Special Report**.) We conclude long-only index funds are a much bigger driving force than the stereotypical "speculators" often cited as the reason behind rising commodity prices.

If we multiply open interest, contract size and price for the CIT universe, we get a total value, akin to a market capitalization, of $151.06 billion as of May 2. Contracts held by long-only index funds account for $62.37 billion of the total, up from under $20 billion at the beginning of 2006, and a threefold increase in the past two years.

Long-only index funds (thin red line, chart below) are the largest participants in the CIT-reported markets, dwarfing positions held by both non-index hedgers and traditional speculators (blue and green lines, respectively, chart below).

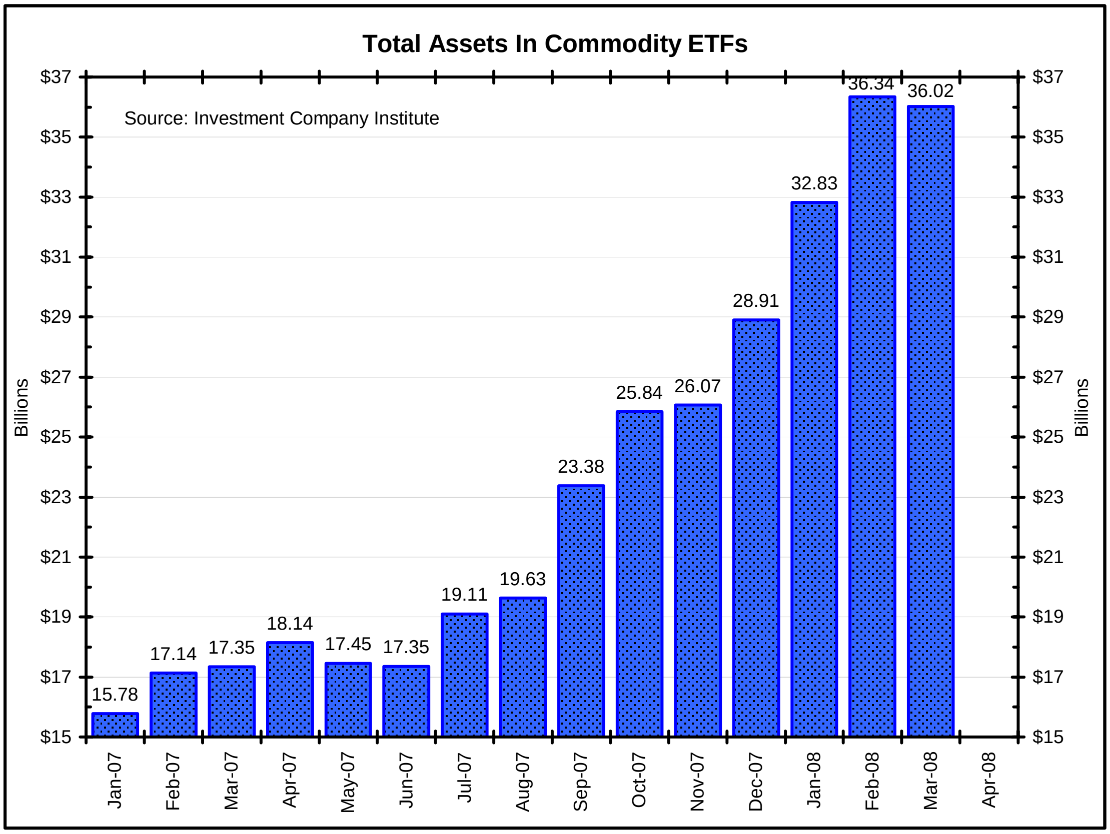
As of May 2, 2008 long-only index positions account for 41.29% of the total market capitalization of these markets. In comparison, the long positions of hedgers account for 27.23% while the traditional large speculators account for 19.99%. The remainder can be attributed to the small trader category (not pictured due to their smaller size).



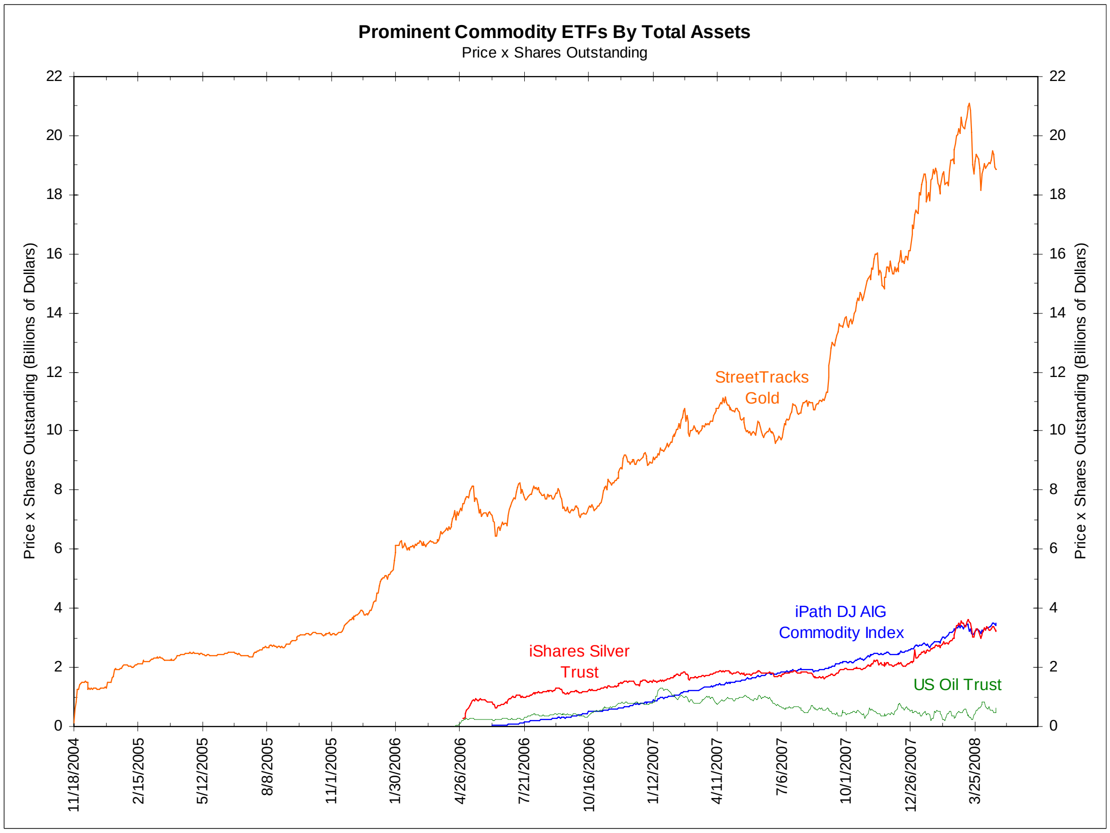

## This Is Also A Long-Only Commodity Fund

So far we have described long-only commodity funds in the abstract. How about a hard example of one or two?

Those familiar with these funds will often think of the massive $220 billion California Public Employees Retirement System (CALPERS) and its 8+% investment ($17 billion) in natural resources and commodities. Many other institutional investors and retirement systems have similar types of investments. However, there is a relatively new category of exchange-traded fund (ETF) that also invests in commodities. These funds have exploded in growth in recent months, more than doubling in the last year and showing no real signs of slowing.




The next chart shows some of the more prominent commodity ETFs. The five funds shown make up $24 billion of the $36 billion total shown above.



While these numbers look small, remember that these markets are not that big to begin with. The total market capitalizations in all the components of the major indices like the Reuters/Jefferies-CRB or the S&P-GSCI is about $650 billion. So ETFs alone are about 5% of this size, up from nothing a few years ago.

If you want an analogy, the U.S. stock market is about $15 trillion in size. Imagine a new buyer that intends on purchasing $750 billion in stocks (5%) over the next few years. Do you think their activity would affect prices?

**Conclusion**

In recent weeks the world has witnessed food riots and hoarding. Basic economics tell us that hoarding reduces supply, which in turn raises prices. Unfortunately the long-only commodity index funds essentially do the same thing; they "hoard" futures contracts. Or, as in the case of the streetTracks Gold shares ETF, they literally hoard physical gold in the basement vaults of HSBC London to the point where they are now a larger owner of gold than the Bundesbank. Reduce supply and the price goes higher.

If these are indeed the "speculators" that are driving commodities higher, then they are not done. The popularity of long-only funds and commodity ETFs is not waning. **The buyers of these funds do not think they are part of the problem of rampant speculation. So, they continue to push money into these funds which helps force prices even higher.**

The traditional "speculators" often referred to in stories such as the one leading this piece do not dominate these markets. They both buy and sell and often choose to remain out of markets. Long-only funds buy and hold, and while their torpid buy-and-roll trading may look sedate in comparison to traditional buy-and-sell trading, it produces greater directional impact on markets wherein it is practiced. The long-only funds are approximately twice the size of traditional speculators' positions, and their rate of growth of assets under management is far higher.

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