The Current State of the Commodity Asset Class

A Discussion with Jim Rogers

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Jim Rogers: JR   Alan Konn: AK

START OF DISCUSSION:

AK: Jim, thanks for taking the time today, you know commodities are tremendously out of favor, investors seem to be running for the hills these days. Maybe there's not blood in the street, but there's certainly oil in the street! What I'd like to do first is step back to when you created this index. There was a pretty vicious bear market in commodities, back in 1997 - 1998 and the world was awash in oil then too. Could you just sort of summarize, why you created an index back then and what you saw back in 1997-98?

JR: Well, I thought I saw the end of a long bear market in commodities and I wanted to invest in commodities. I was about to take off driving around the world and I thought I'd just stick my money in a commodity index fund because I cannot obviously invest while I was driving around the world. And lo and behold, there was no index fund! There were only one or two commodity indexes and they were so hopeless that I wouldn't put my money into them. So, necessity is the mother of invention, there I was, I had to come up with a commodity index in order to put my money in a commodity index. It was pretty simple. That's why I did it, the others as I say were useless from my point of view as an investor; they had various problems. So I came up with my own commodity index. I wanted to have something that would reflect the cost of doing business around the world, the cost of being alive, and the cost of just surviving in the world. So I sat down and did some research figuring out what you would need. It had to be something that was publicly traded obviously and it had to be something that was liquid, obviously. I came up with what I believed to be a better commodity index based on consumption or based on people being alive and consuming commodities.

AK: So you really didn't set out to do an index initially. You first took a look at the indices at the time; Goldman Sachs Commodity Index was around, the CRB and I believe the DOW AIG, today of course it's the Bloomberg. Were you able to examine that index as well before you made the decision to make your own?

JR: Yes, there was the Goldman Sachs which at that time was more than 2/3rds oil. Well, that's not an index. I looked at the CRB. At that time, in the CRB, everything had an equal weight, I mean, orange juice and oil had an equal weight?! So I looked at this and thought, that's not reality, that orange juice and oil have an equal weight for instance. And it's not reality that oil is more than 2/3rds of an index. That's nobody's real life. So, because of the problems with the other indexes, I had to come up with my own. This was designed for me to put my own money to work. I didn't grow up thinking someday I'm going to have a commodity index. I just was forced to do so because of the circumstances of being bullish on commodities in 1998. It actually started with real money August 1st, 1998. My sense of timing was not too bad. I got as close to the bottom as I ever got with that commodity index. Commodities hit their bottom a few months later and it's been up ever since.

AK: It's interesting, looking at the data, the actual bottom of commodities was indeed February 1999 and they were terribly out of favor at that time. This index was up almost 60% in the next 2 years after that bottom.

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JR: I know, I'm shocked that I got it so right but I apparently did.

AK: So, let me ask you, your Index is consumption based which seems to make a lot of sense. The others have different methodologies. Maybe you can speak a little bit as to what your philosophy is on changing the index. As you know I've attended the last two index committee meetings so I've been there but when you created this Index, what is your philosophy on changes and what does it take to make a change based on consumption.

JR: Well, a good index would never change. A great job would be to get it right when you set out. But, since the world does change you have to change the composition and the weighting as the people's consumption patterns change. If we find out cotton causes cancer, obviously the use of cotton is going to collapse and you'll have to change the weighting of cotton. Or if you find out copper cures cancer then you will have to change your weighting of copper because more and more people will use copper. So there have been a few changes, very few, I would have to say mostly de Minimis. Over the years a couple things were dropped. We had silk in the index in the beginning but the silk market dried up and the market for silk futures dried up so we had to drop it. Even that was such a tiny percentage at the time that very few people would have even noticed, including me.

AK: In the construction of the index what is also interesting is there is a monthly rebalancing in your index which we've studied and it actually adds some value versus annual rebalancing for example. How did you come up with monthly rebalancing?

JR: Well, it's just experience in the markets. I know that prices do change and we need to keep current with the markets. If you wait for a year, if commodity "X" triples in a year and you don't change it for a whole year then you have distorted the whole purpose of the index. Most things don't triple in a year but you do have big moves in some things. You should be rebalancing somewhat frequently in order to keep the index in touch with reality.

AK: It certainly has some added value, not each and every year but it has over the life of the Index. There's a lot of discussion and a lot of new indexes have been created in the last few years trying to capture the popularity that commodities finally got back in 2006-2007 before the credit crisis. A lot of them are trying different kinds of roll methodology. How did you determine your roll methodology?

JR: I wanted it to be close to the real cost of being alive or the cost of doing business and obviously you would want to use spot but you can't use spot in an index when you're in futures. So, I wanted it to be the closest to spot that we could get. Obviously the very nearest contract is too distorted so use the second closest futures month maturity in order to be as close to the spot market as we could be without being in the delivery month. A guy who's building a house is buying copper today, he's not buying it a year from now or six months from now. If he's eating rice he's eating rice today, so you have to try and get as close to the spot as you effectively can to get the real cost of being alive or the cost of doing business.

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AK: That's really interesting. After all is said and done, when you roll, where you are on the calendar and never being in a delivery month actually add value versus the way some of the established indexes roll. You did this because you looked at it and it was common sense, good pricing and you were just trying to capture a good price point but it has added value. Does that surprise you?

JR: Yes, I'm glad you told me that, I didn't know that it would add value. I was doing it based on my experience in the past and considering I wanted an index that I would invest in with my own money. This was designed purely and simply for me to invest in as an investor with real money, not clients, not other people's money, but my money. Some of the other people arbitrage against their clients, etc., etc. Well, I didn't have any clients at the time. I was just looking for a way to put my own money to work while I went off around the world in expectation that a bull market in commodities would be starting soon.

AK: It's a great story. Now you have the index committee; did you have the index committee from the start?

JR: Not from the start, but shortly after I came back. The index was gaining some traction with some investors and I realized that someone has to oversee this because if I drop dead there needs to be somebody who can give some continuity and supervision; (and I should have created the committee before I started driving around the world), So, I decided, let's put together a committee based on knowledgeable and learned people who know the industry so that if something needs to be changed then we can change it. The concept of the committee was we would meet formally at least once a year. But also to make sure if something comes up, if copper causes cancer, we can have a meeting anytime we want. Formally, to supervise things and look after things we meet once a year, whether we need to or not.

AK: Jim, I'd like to switch a little bit and discuss the state of the asset class today, 16 years later, Your index, as many investors know, has compounded annually at over 300 basis points more than the Bloomberg Commodity Index and even more than that over the S&P Goldman Sachs Commodity Index. The portfolio you put together for yourself certainly has stood the test of time over 16 years and it's been consistently better. The biggest question now it seems, what is on investors' minds, is less "which index" or "how do they get long commodities" but should they even be in commodities at all. This is the longest number of calendar years that have been negative in the benchmark index, the Bloomberg Commodity Index. Actually, the Rogers International Commodity Index® was up one of those years. This is the longest downturn, not quite the steepest, but about as steep as 97-98. Is this bear market, is it similar to other bear markets in your opinion regarding commodities?

JR: I'm glad you told me that fact, I wasn't quite aware of that fact. It's a good thing to know, it just makes me more bullish on commodities. All bear markets or all market declines are painful if you're long, there's no question about that. Anybody who has been long commodities has suffered during this period of time. Is it worse? I don't know but probably it's a bit worse today perhaps because in the past in commodities you didn't have as many financial types in the markets. Now with more financial types in the markets, that usually causes more swings, whether we are talking about stocks, bonds, commodities, whatever it happens to be.

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And the other thing of course is oil. This whole fracking situation and the political situation with the U.S. If you go back and look Alan, you'll see that last year America and Iran were in serious negotiations and they had a deadline of July, it came to an end and having failed they said, lets extend the deadline for another year and we'll continue to talk. If you get out your charts you'll see that that is when oil started going down in a big way as America persuaded Saudi Arabia to dump oil on the markets in order to put pressure on Iran. The charts are almost magic the way that they correlate with the negotiations with the US and Iran. Of course, America wanted to put pressure on Russia at the same time. Saudi Arabia was delighted to do it because the fracking in the U.S. was causing some problems, its bringing new supply into the market. Saudi Arabia thought if they dumped the oil to help America with Iran and Russia it would also help us to delay or slow down the fracking boom. You can't stop fracking but you can certainly slow it down if you get the prices low enough. At some point people just stop putting money into fracking when prices are low enough. Now, Saudi Arabia knew that, America knew they could pressure Iran. So low and behold, we had this artificial political move in oil, therefore in energy. For that reason, we had a bigger collapse, in my view, than we would have if it were just market forces. I don't think in the 70s, 80s, and 90s we had that sort of political maneuvering in oil and other commodities, in any commodities. It really couldn't happen with most commodities because there's not a single dominant player like there is in Saudi Arabia and they had enough reserves to act and they did.

AK: That's really interesting, it's really insightful as to maybe what is happening with oil. But, if you step back, you've said before that it's hard to really measure what proven reserves are. As an investor looking out after this collapse in oil, and there has only been this steep of a decline in this short a period of time three other times: 1986, 1999 and 2008 where there was this drastic of a decline. No one knows where the bottom is going to be, no one knows if these political maneuvers will continue but if you step back and say, as an investor in commodities, and oil being one of the major ones, what would you say about where you might think the prices will be 3 to 5 years from now?

JR: Well, I do know factually that the world has consumed more oil than it has discovered in the last few years. Last year was a real disaster, we discovered very little oil. Except for fracking, the world has discovered very little oil, and certainly in 2014 very, very little. And we continue to consume oil and the oil consumption continues to grow. So the overall reserve situation in the world has problems except for fracking and that means eventually the price of oil has to go much, much, much higher. These fracking wells are very short lived wells as you know, production drops dramatically in a year or two and you have to keep drilling in order to keep it up. The fracking industry as a whole has had a negative cash flow over the last year or two, or three because these wells decline so very, very quickly. Where will the price of oil be in five years? I don't know Alan, you're a commodities broker, you've been around markets a long time, I know it's going to be higher than today, exactly how much higher I don't know.

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AK: Let me switch to another subject. A few years ago around 2010, 2011 or so as the Fed was printing and quantitative easing was starting, investors seemed to be en masse worried about inflation, yet we haven't really had inflation, at least not measured by CPI I suppose. There is a lot of talk now about deflation and the Fed is working hard as they are trying to re-inflate as I think others around the world are. What are your thoughts about whether we could potentially be in an inflationary or deflationary spiral? Do you think all this printing will eventually lead to inflation and it's just a matter of time? Where do you stand on deflation versus inflation?

JR: Well, we potentially can have anything. There was inflation, the US government said there was no inflation but nearly everybody I know, knows that there was inflation. Some governments acknowledged it, Australia, China, India, Taiwan, Norway, there were plenty of governments that acknowledged that there was inflation. Anybody who shops know prices were going up. Even today, if you look at the prices of most things, except energy, you will see that prices have been going up, despite what the US government says. This year of course, prices are down because the price of oil has collapsed, we discussed that before. There is not much inflation at the moment. Energy is the single most important commodity for everybody in the world, nearly everybody in the world depends on it. Can there be deflation? Of course there can be deflation but when you have people printing a lot of money that, nearly always throughout history, led to inflation and led to higher prices. I suspect it will again. I don't think that the world has changed so dramatically that money printing doesn't or might not lead to inflation. It may not be the next day, but it always has led to inflation and I suspect it will again in the future. Especially once oil prices start going up again. We have discussed, they will go up again and why they will go up again. Once that happens you'll see higher prices for nearly everything.

AK: It's interesting. Investors in commodities are waiting for higher prices. I don't know if you are aware but the average price of commodities in the Rogers International Commodity Index® is down on average about 50%. Not all of them, some more than that, some have done a little bit better. But on average, pretty broad, in agriculture, the metals both precious and industrial and of course energy with the greater than 50% decline. You've mentioned before that in reference to gold you might be looking for a 50% retracement before it's over. Now we've had, on average a 50% retracement in most commodities. Do you think we are close to the bottom? Are we close to the printing of money starting to lead to higher values in real assets?

JR: Absolutely. I'm glad you pointed out that number. I've been around markets a long time Alan, and you have too. A 50% correction is normal every 3 or 4 years. For whatever reason, we have a 50% correction, there's nothing magic about it, it just happens. It's not unusual. So the fact that nearly all commodities have gone down or have had 50% correction is normal and to me it signals that we are close to a bottom. But again, I am useless at market timing but I know a lot of market history, I've been around a lot of markets, and I know that 50% corrections occur, they're normal, they're usual. There is always a reason they take place and it usually means you should start buying again not selling.

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AK: One more question comparing today to the time you started building your index. The seeds of tighter supplies in commodities seemingly are being planted now and by that I mean, if you look at the mining companies, many of them are merging or selling assets as opposed to investing and putting more capital into building these long term assets. So you're seeing the capital markets forcing a change in the investment side of suppliers of commodities but it takes time. One of the things you talked about when you created your index was that there was a lack of money that had gone into building the supply side of commodities back in the late 80's and 90's. Do you think we are there, in a similar place again where supplies are tight and over time demand will continue to grow? Have we reset the dial?

JR: Yes, this has been going on throughout history for hundreds of years. When supply starts drying up and prices go down people stop spending. It will happen again, it's normal. It has always happened and it has always led to higher prices down the road, there is nothing unusual about it. It happened in the 90's which is why the commodities bear market came to an end and it's happening now. All the metals companies have cut back dramatically, the oil companies as we have discussed, and there is a huge problem in agriculture in that we're running out of farmers. The average age of farmers in America is 58. Agriculture has been such a horrible business. In Japan the average age is 66. I can go on and on about the shortage of farmers that is developing worldwide. Agriculture is going to have a serious crisis sometime in the next few years. It's not just the prices, we won't have any farmers. You have to get prices up first in order to attract capital labor and management in any field, and certainly in agriculture.

AK: I'm sure before the end of this call you're going to give me a little bit of advice which would be to get off the phone and go learn how to drive a tractor. I've heard you give other people that advice and trust me, it's in the back of my mind.

JR: Absolutely, go buy yourself a farm, learn to drive a tractor and you'll be much better off in the future.

AK: A couple more questions, you've often said that, though people don't believe you, you are not a great short term timer but you've been long the dollar for a few years now, and boy correctly so, especially in the last year or two. You're saying in part that a crisis in currency markets leads to people buying the Dollar, any thought as to how long you will stay long the Dollar?

JR: I was actually pessimistic about the Dollar for a long time but over the last couple years I changed my view on the Dollar. The Dollar is a terribly, terribly flawed currency. It's got horrendous problems and I believe in my children's lifetime and maybe even in my lifetime the Dollar is going to disappear as the world's reserve currency. Because, the US is the largest debtor nation in the history of the world and the debts are going through the roof. Nobody seems concerned about it but you and me and a few other nuts like us. But since the Dollar is reputed to be the world's safe haven, that's the term that people use, there's going to be a lot more problems in the world. We've already seen problems with the Yen, the Ruble, I can go on and on with currency problems.

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AK: Today, some people don't want to invest in commodities now because their thought process is that when the dollar is strong commodities can't go up. Do we need a weak dollar for commodities to go up?

JR: That will lure some people in but the people who say that are factually incorrect. You can have the Dollar going up and commodities going up at the same time. I'm old enough to know that it can happen and it has happened in the past. Yes, when you see commodities going up and the Dollar going down you start putting together a correlation but it's not an accurate correlation, it's not based on fact. The problem with the investment world is if something happens for a year or 2 or 3 they all say "aha, that's the way the world works". Well, that's not the way the world works, most people don't have time or interest in going back to look the facts up.

AK: For many allocators commodities is a core asset class but investors are concerned mainly because we've been in a bear market and we're sitting with equities that have been really strong and recovered to all-time highs, we have bonds at basically all-time highs, we have real estate that has recovered at highs, and lonely commodities are down 40 or 50% and people still don't want to invest, any last thoughts on that?

JR: That's the way things always are as you know. When things are going up people want to invest, they don't want to invest when things are down or when they're going down. You and I and anybody who has read any books at all know we're supposed to buy low and sell high. But, getting people to do that is almost impossible. They want to see it going higher. My mother used to call me and say "please buy me this stock". I'd say "why" and she'd say, "well, it's tripled." I'd say, "Mother, no, no, no, that's not when you buy it, you're supposed to buy it before it tripled!" But, getting people to do that is very difficult. It's usually only the smart money that will buy something when it's down before it starts going up. In my view, the smart money should be buying commodities now for all the reasons you have mentioned, the facts you've mentioned and the things we've discussed.

AK: Jim, I really appreciate you taking the time to discuss the asset class. It's really topical today as people try to figure out where to put their money and how to protect their portfolios. I look forward to maybe a year from now we'll have a similar conversation and we'll see if the world has changed a little bit.

JR: The world is always changing and I assure you, if commodities are down a year from now for whatever reason you should buy more, not sell! Alan, supply and demand continues to get out of whack! The world has been consuming more oil than it's been discovering for quite some time now and world reserves are going down except for fracking and fracking is short term reserves. And there is huge negative cash flow in this industry and this cannot go on.

AK: Jim thank you for all your input, this is really great stuff.

JR: I look forward to seeing you Alan, where ever our paths cross next.

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