

R I V E R P O I N T R E P O R T

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RIVERPOINT'S TAKE ON COMMODITIES AND GOLD

Commodity prices have enjoyed a strong run over the past twelve months. A broad range of commodities ranging from cocoa to sugar to cotton to gold to silver have all appreciated at least 40% over the past year (even coal has rallied over 10% in recent weeks – is Santa driving increased demand?). This strong price performance has caught the attention of both the financial and popular press. This issue of the *RiverPoint Report* delves into why investors hold commodities and what we are doing for our clients in order to deal with those same issues.

Firstly, we would like to point out that for years savvy investors have paid close attention to popular sentiment as a contrarian market indicator. The basic theory is that an investment trend is likely ending just as it captures the public's imagination. As the popular press features the topic with increasing regularity, the theory states that the general public will be grabbing a seat at the table just as the "smart money" is cashing in its chips. For example, if *Time* and *Newsweek* both have cover stories about the investment value of baseball cards, behavioral finance would indicate that now would be a good time to sell what is left of your childhood collection. The theory followed the script to a "T" in the early 2000's with the tech bubble and again last year with oil prices. On the morning of November 24, 2009, CNBC ran a feature report titled "A Modern Gold Rush." As baseball Hall of Famer Yogi Berra once said, "This is like déjà vu all over again."

There are several good reasons to own commodities, and our client portfolios have exposure to commodities through ownership of energy and material stocks. The prices for physical commodities have historically led financial assets as the economy comes out of a recession, in anticipation that a rebound in manufacturing activity will boost demand for commodities as a whole. This is particularly true for commodities used as raw materials in a variety of industries like oil, copper and steel. Investing in commodities is also widely viewed as a way to hedge against inflation. As inflation and rising interest rates destroy the purchasing power of fixed-income securities, commodity prices typically rise in concert with general price levels. This price appreciation offsets the potentially damaging impact of rising rates.

Recently, commodities have been seen as a particularly popular hedge against the falling value of the U.S. dollar. The investment thesis is that foreign investors with dollar balances have to put money to work somewhere; instead of selling their dollars at depressed prices or investing them in U.S. securities offering paltry yields, foreign investors are buying commodities priced in U.S. dollars. There is also a "head for the hills" perspective, where physical commodities like gold are seen as the ultimate safe haven. This group increasingly questions the success of global stimulus efforts, and many of these investors worry that an ongoing economic malaise will force governments to continue to issue new debt in the face of large budget deficits. These pessimists believe that gold, due to its natural scarcity and precious nature, will be the only asset of value if the loss of financial flexibility threatens governmental stability around the world.

At RiverPoint, we are hesitant to invest in physical commodities, like gold bullion, at this juncture for several reasons. From our vantage point, the rally in commodity prices has been a little too exuberant – commodity prices may not represent a full-fledged bubble but definitely seem to have overshot any improvement in the underlying supply-and-demand fundamentals. Record amounts of cash have flowed into the commodity space in 2009, especially gold, giving evidence of speculative frenzy surrounding the asset class.

According to researchers at Goldessential.com, the amount of gold currently held by exchange-traded funds (ETFs) and speculative futures contracts roughly equals annual mine production. This is an unusual circumstance and demonstrates the voracious investor appetite for gold, leaving little of the precious metal for jewelry or industrial uses. The price of an ounce of gold has been on a decade-long tear, surging from late-1999 lows of around \$250 to its current price of roughly \$1,100; crude oil experienced a similar rise in per-barrel prices from the low-\$20's in late 1999 to nearly \$150 last July. It is interesting to point out that the parabolic trend line in the price chart for gold currently looks eerily similar to oil's chart prior to the latter crashing in 2008. Interestingly enough, the longer-term inflation-adjusted performance of gold has been dismal relative to other asset classes, especially equities. Gold hit a then-record high of \$875 per ounce in 1980, which translates into a price of over \$2,100 in today's dollars. The S&P 500 hit a high of 140 in 1980; adjusted for inflation, the index would be trading around 350 today, instead of the current 1,100 level.

At RiverPoint, we are skeptical of the staying power of the current trends in commodity prices. There is enough slack in the economy at this point to temper the inflationary impacts of the government stimulus. Wage inflation is a large contributor to overall inflation, and with a weak job market in the cards, inflation will be muted at least for a while. Manufacturing capacity utilization is also low, which should give the economic expansion more room to continue without exerting upward pressure on prices. The odds of runaway inflation are slight, but we are hedging this possibility by owning shares of energy and material stocks. Instead of chasing the underlying physical commodity, owning shares of companies like BHP Billiton and Occidental Petroleum is preferable because they benefit from rising commodity prices yet still have value as ongoing concerns. These companies provide investors with sensitivity to commodity prices but also possess hard assets, managerial acumen and growth prospects that would protect investors on the down side should commodity prices begin to fall.

A weak U.S. dollar is another concern to many investors. To protect against this issue we have established positions in client portfolios in companies that generate a substantial portion of their business from overseas markets. Global giants such as Procter & Gamble, 3M Companies, Hewlett Packard and United Technologies all generate a large portion of their revenues from non-U.S. markets. As the dollar weakens, these companies are able to exchange revenues denominated in foreign currencies for more U.S. dollars, benefitting underlying results. We strongly believe that it is better to own shares of high quality, industry-leading global companies to hedge against a falling dollar than chase a hot commodity up a steep price trend.

<u>Market Summary</u>	<u>12/2/09</u>	<u>2009 Price Change</u>
Dow Jones Industrial Average	10,452	19.1%
Nasdaq Composite	2,185	38.6%
Standard & Poor's 500 Index	1,109	22.8%

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