BARCLAY MANAGED FUNDS REPORT

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BARCLAY ROUNDTABLE

Soaring Commodity Prices Coupled with Fed Easing Fuels Inflation

Supply/Demand Imbalances May Only be Part of the Problem; Is the Weak Dollar Also to Blame?

Collateralized debt obligations, bespoke swaps, credit default swaps on the residual tranche of a sub prime mortgage collateralization. Confused? It's hard not be. This stuff may sound pretty interesting when dealers explain the great yields and frothy prospective returns. But what is really behind these investments? And as we've seen very recently, where is the liquidity when we need it?

Contrast the above to the commodities markets where your investment is simply backed by wheat, gold, oil, cattle, etc. It's very simple in theory, non-correlated to many of the major asset classes, and historically very liquid. So are commodities the next great frontier for investors seeking returns? Those who have been invested over the past 12 to 18 months would certainly agree, as gold, oil, and wheat have skyrocketed to historical levels of $1,000, $125, and $12.75 respectively. And if you're invested via a fund manager, your results are likely to have been equally pleasing, as the Barclay Commodity Trading Advisors Index returned +7.4% during the first quarter of 2008 and +18.0% for the trailing 12 months through March 31, 2008.

While the results have been fantastic, the question remains: How have we arrived at these levels? Do the supply and demand fundamentals justify the results? Are we witnessing the beginning of our next bubble, or is a favorable commodity market here for the long haul? To answer these questions and explore the case for commodities investing in more detail, we have assembled the following panel of experts:

Sebastian Barrack, Macquarie Investment Management, Ltd. Mr. Barrack is an executive director at Macquarie and runs the Agricultural Commodities and Investor Products Division. This division is made up of 70 people across 4 continents and encompasses trading, risk management, financing, and physical transactions in the commodity space.

Brad Cole, Cole Partners Asset Management LLC. Mr. Cole is President of Cole Partners Asset Management, LLC and Cole Partners LLC, overseeing all investment, management, and strategic activities of the firm. His professional career spans more than 20 years in the derivatives industry as a trader, portfolio manager, and investor. Cole Partners Asset Management manages the Tellus Natural Resources Fund, a multi-strategy fund of hedge funds dedicated to the commodities/natural resources sector.

Jodie Gunzberg, CFA, The Marco Consulting Group. Ms. Gunzberg joined the Marco Consulting Group in 2007 as Director of Research/Manager Search, where she is responsible for investment research and manager selection. She has several years of investment experience across asset classes including equities, fixed income, real estate, hedge funds, and commodities. Prior to joining MCG, Jodie held various analyst, portfolio management, and risk management positions where

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Past results are not necessarily indicative of future results. An investment in commodity futures and options involves the risk of loss. Please read the important disclosure on page 23.

she built security selection models and risk management systems, and engineered new strategies. She has also written publications on commodity and hedge fund investing.

Hilary Till, Premia Capital Management, LLC. Ms. Till is a co-founder of Premia Capital Management, LLC, a proprietary investment and research firm. She is also the co-editor of Intelligent Commodity Investing, Risk Books (2007), is a research associate at the EDHEC Risk and Asset Management Research Centre, and is an advisory board member of the Tellus Natural Resources Fund.

Q: Most commodity indices are heavily weighted in energy, primarily oil. No doubt oil has been the headline over the past 12 months as prices have reached historic levels. There have, however, been significant gains by less "flashy" index components (e.g., wheat) over the past several months. In your estimation, have the most successful trading programs been oil-centric, or is there significant potential value added by straying from the typical index weights? In which commodities would you recommend an overweight position over the next 12 months? Which would you underweight or short for the same period?

Barrack: At the inception of any bull market one can achieve returns at the simple broad index level. For the commodity bull run, investors didn't need to stray far from an index that was heavily crude oil weighted that invested in the rolling spot contract. However, as the bull market has matured, the allocation across commodity sectors has become more important. Initially the energy sector led the commodity story, followed by base and precious metals and now the agricultural sector. Our belief is that the livestock sector will follow as the next sector to outperform. With such high feed costs and shifting diets toward protein in Asia, we see the prices of meats increasing over the next 12 -24 months.

We still favor being overweight agricultural commodities such as corn and soybeans that are used for biofuels production. The global government-mandated production of biofuels, competition for acreage, and dietary expansions in populous emerging markets will create long term supply shortfalls that will keep prices high. A knock on effect will be for cotton. As cotton acres are squeezed out at the expense of soy and corn, coupled with soaring textile demand in Asia, we believe we will see prices significantly higher by the end of 2008.

The one exception is sugar. With such a large surplus this year, we are keeping our price projections flat for this year, although we expect them to bottom out in early 2009.

Sebastian Barrack
Macquarie Investment Management, Ltd.

"Gold has been the perfect long commodity/short dollar play for investors."

We would favor being underweight gold as the dollar should stabilize as the global slowdown permeates through the rest of the world. We would also underweight wheat. The high prices of wheat seen at the end of last year have attracted enough planted acres to increase production to a level that will cap prices rising further in the next 12 months.

Cole: The fourth quarter of 2006 has been the launching pad for the biggest grain move since the 1970s, and with a few bumps along the way, the grains have been a major P&L contributor for the CTAs through the first quarter of '08. Both precious metals and some of the more exotic base metals have been strong, and the softs market is moving as well. So I don't think the CTAs are oil-centric per se, but there is much more capacity (volume and open interest) in energy over agriculturals and there are a greater number of managers that are oil or energy-centric/specialists, especially on the equities side.

Having said that, we still have a healthy weighting to energy and agriculture because of persistent volatility and continued supply/demand disparity. But remember, our managers are not long only. They can trade long or short, directional or relative value, futures or equities. The challenge for us is finding great managers in all the areas we find fundamentally appealing. So weightings in our portfolio (as a multi strategy fund of funds) will tend to be different from the long-only indices.

Gunzberg: While there have been some very successful oil-centric programs, they lack the diversification for long-term benefits derived from investing in commodities as an asset class. Generally commodities have low correlations among sectors with different business cycles. For example, it may take ten

years to get a mine up and running for base metals, whereas it only takes nine months to significantly increase the supply of hogs. Furthermore many commodities besides oil, such as platinum, wheat, corn, and soybeans, have reached historic levels recently, so commodity programs have not needed to be oil-centric to generate high returns. Lastly, oil-centric programs, especially long-only strategies, may exhibit excessive volatility with severe drawdowns. Recently, in the period from August 2006 through January 2007, GSCI suffered a drawdown around 23%.

According to the managers we talk to, base metals, precious metals, carbon, and select agricultural commodities appear to offer the most attractive risk/return profiles in the near future. The short-term mania in food is from low stock in many of the softs primarily due to the drought in Australia. However, the burning of food for fuel is longer-term and is pulling supply away when the market is already focused on inflation.

Also, according to the managers we talk to, economically sensitive commodities are the best to underweight. These include industrial metals like copper and steel. The managers also recommend to underweight cement, non-ferrous metals, and timber.

Till: The returns that one could earn in commodity futures have diverged widely, depending on one's specialty. For example, since the end of December 2001 through the first quarter of 2008, the holding-period returns have varied from -14% for livestock to +344% for industrial metals.

Choosing how to invest in commodity futures depends on one's rationale for investing. If the point is diversification and having something in one's equity-and-bond portfolio that does well during an unpredictable (but entirely possible) oil shock, then an oil-centric index will clearly be the best decision. The first generation of commodity indices had been built around providing this sort of diversification, given the experience of the 1970's.

If one's view is that Asian growth is driving a second industrial revolution, then a metals-oriented index has and will provide the best exposure to that theme.

Brad Cole

Cole Partners Asset Management LLC.

"The 4th quarter of 2006 has been the launching pad for the biggest grain move since the 1970s..."

Now, even in a secular bull market, the prices of individual commodities can decline by -30% to -50%, so if one is looking for a stand-alone investment that will make money over shorter time-frames, there are a number of long/short systematic strategies or indexes to consider.

That said, my proprietary trading firm specializes in relative-value relationships. An interesting aspect of the commodity futures markets during the past three years is that numerous empirical regularities, which relied on the U.S. as the dominant participant in commodity markets, no longer work. This is the first business cycle in which Chinese demand has had such a global effect on both absolute prices and relative-value relationships. So from the standpoint of a spread trader, the most reliable opportunities have been and continue to be in futures markets that are largely domestic.

Q: Gold has also been a major headlining commodity recently despite representing only a minor portion of most commodity indices. The press tends to emphasize gold as a counter to the weakening dollar. To what extent has the weak dollar been a factor in the ascension of gold prices? Are there any other significant fundamental reasons for gold's lofty valuations? How much have technicals supported the price?

Barrack: Gold has been the perfect long commodity/short dollar play for investors. Unlike any other commodity, gold has long been an investment vehicle prior to the popularity of the commodity indices. With the likes of Warren Buffet telling the world to hold zero investments in USD, being long gold has also been a portfolio hedge for many investors that have large USD exposures in their portfolios.

Normally viewed as a safe haven, gold is also treated by investors as a hedge against inflation, and with oil and food prices threatening to raise inflation rates, investors have been given another reason to pile into the gold market.

In addition, the fundamentals do play some part in the gold market. Investment demand for gold is expanding rapidly, offsetting slower physical demand growth

(although jewelry demand in Asia continues to rise). Yet, supply at the mines is failing to catch up. In 2007, mine supply fell to an 11-year low, with output down everywhere apart from Asia. Mine closures, rising costs, and power issues are just some of the factors behind this. In the second half of 2007, when gold prices averaged over $700 per ounce, some South African producers were still struggling to make money – a remarkable situation when you consider that five years earlier, gold was trading around $300 per ounce.

Cole: Many of the gold bulls we talk to express their views through equities using global mining equities. While they cannot hide the fact that current US policy for a lower dollar remains their highest picture card, there are a number of other fundamentals in play, such as storing wealth, as many emerging economies, buoyed by their strong GDPs, tend to buy gold as an augmentation to traditional bank savings instruments. The current US account deficit is bullish for gold; looming inflation is bullish for gold. The soiling of the global credit market and the geopolitical sky-is-falling environment are bullish for gold as well. But at some point the cost of production and a tepid equities market will begin to work against the equities play. For the bigger CTAs, gold futures account for surprisingly less of their P&L than one might think, perhaps because versus gold, the dollar is just a cleaner play and subject to less volatility during market corrections.

Gunzberg: Given gold is priced internationally in dollars, a fundamentally weak dollar (as we have now from interest rates lower than the European Union's) that leads to inflationary prices will cause a rise in gold. So, most of the move in gold can be attributed to the weak dollar, which is historically consistent as shown by the negative correlation between the two. For example, in the past year gold has gained about 40%, and the dollar has fallen about 15% against the euro. Roughly, then, perhaps the fall in the dollar accounts directly for over half (1.40/0.85-1) of the rise of gold's price. However, that calculation understates the impact of the fall of the dollar, because gold is seen as a store of value.

Jodie Gunzberg, CFA
The Marco Consulting Group

"... economically sensitive commodities are the best to underweight."

Today, gold makes up a relatively small portion of the world's wealth, as opposed to the situation in 1980, where gold represented a huge portion of the world's wealth. So, some think a lofty valuation of gold would be closer to $3,000 per ounce. Nonetheless, there is a strong fundamental case underpinning the high price of gold. On the demand side, global investors are investing in gold not only as an inflation hedge but because of newly found wealth in emerging countries like China and India, where the people have a strong affinity for gold jewelry. Additionally, the advent of the physically-backed ETFs has made it very easy for investors to obtain exposure. On the supply side, a lack of investment in mining and mining-related infrastructure has meant that production has not kept pace. For example, South Africa, one of the world's top four gold producers, has seen production drop steadily for more than a decade and now produces the same amount of gold as it did in the 1930s. Apparently, the state-owned electric utility can only promise 90% of the electrical needs of the mining industry. Further, central banks had been selling gold for years but have stopped. They could reduce their stores, but would again bear on the value of the dollar.

Commodity indices and Commodity Trading Advisors (CTAs) are seeing substantial inflows. While gold may be a minority weighting in most indices, the volume may contribute to the rise in price. However, mostly all CTAs' systems include gold, and their technical models are supporting long gold.

Till: The weak dollar really needs to be brought more into the spotlight in understanding the broad-based commodity rally. Marc Faber has written about how cash is losing its purchasing power at an accelerating rate against other assets because of expansionary monetary policies. He discussed how a new monetary system based on precious metals has become a *de facto* reality.

From December 31st, 2001 until the end of last year, front-month crude oil prices increased by almost 400%. But if one denominates oil in, say, fractional ounces of gold rather than in dollars, one comes away with a rather different picture. Using gold as the "unit of account", crude has instead rallied only 61%

over the past 6 years. Therefore, I'd conclude that the rally in crude has been more of a monetary event than a physical commodity scarcity event. Gold needs to be viewed as a currency with store-of-value properties that appear to be missing with other currencies, particularly the dollar.

That said, in dire economic circumstances, one cannot rely on gold as a store-of-value since, historically, private holdings of gold can and have been made illegal, as was the case during the Great Depression, and which was explained in Bridgewater Associates commentaries. In other words, even holdings of gold rely on a well-functioning financial system. So a weak dollar is good for gold prices, as long as the dollar does not become *too* weak!

Q: Commodity trading strategies can rudimentarily be divided into discretionary and systematic programs. How does the current and prospective fundamental landscape favor discretionary strategies? In your opinion, which commodities continue to have favorable fundamentals? Which do you see as overvalued? What technical features of the current commodities landscape favor systematic trading programs?

Barrack: Broadly speaking, systematic strategies outperform discretionary strategies in trending markets, as the fundamental traders give up on the belief in the trade well before the system gives a signal to exit. So in the past 7 to 8 years systematic traders in commodities have fared very well as price levels have gone well beyond historic highs.

Fundamental or discretionary traders in commodities start by analyzing the "balance sheet", or market fundamentals. The commodity balance sheet is not made up of assets and liabilities, but supply and demand. The importance of this analysis is on future projections of how "tight" or "loose" the balance sheet will be. When we forecast a tight balance sheet, we are predicting shrinking supplies versus demand, and this will put upward pressure on prices such as we are seeing across markets like corn and soybeans. A common ratio we also look at is the "stocks to use" ratio, which literally divides how much supply we have in reserve by how much we consume on an annual basis. When this ratio gets lower, as we saw across all the base metals two years ago, this forces prices higher so as to ration demand. In some markets, such as spring wheat and nickel, the stocks levels reached such low levels that prices were forced to rally by 500-1000% to ration demand.

Hilary Till

Premia Capital Management, LLC.

"... the rally in crude has been more of a monetary event than a physical commodity scarcity event."

Going forward, the corn market will be the next to reach precariously low stocks levels that could cause prices to rally further than anyone will imagine over 2008.

The technical features of the commodities markets that have allowed systematic traders to perform so well recently is the fact that prices have blown through historic highs. The typical "Turtle Trader" strategy of buying each time the market makes a new high has proved very successful in the commodities markets this decade.

Cole: Our fund blends both discretionary and systematic managers. We have noticed that the two groups are actually pretty correlated, especially in times of big run ups and big drawdowns. The differences are really determined primarily by asset allocation, as some discretionary managers are sector specific, such as agriculturals only, or energy only. However, most of the bigger managers are diversified across sectors. Again, the big difference between discretionary and systematic is that the discretionary manager usually chooses the best fundamental opportunities (more concentrated), and the systematics will be more diversified.

Based on a number of themes, long-term fundamentals for most listed commodities are good. This is based on strong emerging market GDP and a significant upturn in consumer population demographics in the BRICs countries. In addition, food for fuel and early signs of inflation all add up to higher commodities prices. However, near term commodity cyclicality and heavy speculative activity can create huge volatility in these price trends. As we are seeing historically high prices, investors must be aware that we will see unprecedented volatility in these markets as well, across the board!

The current environment is positive for both fundamental and dis-

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cretionary strategies, but each has its limitations. For example, as prices trend and then correct, trend following systematic managers typically suffer meaningful P&L givebacks. But in a generally trending environment, the recovery period can be relatively short. Discretionary managers tend to suffer when exogenous or systemic issues cloud the fundamental landscape. Credit market meltdowns and the bailout of Bear Sterns have very little to do with the fundamentals that drive the price of corn or copper, yet these markets were hit badly as there was a global rush for liquidity. So it's never easy, but the current long-term picture is still positive for discretionary and systematic managers.

Gunzberg: If we are in the fourth inning of a long-term bull market where prominent Asian demand will drive prices higher, volatility will also rise. As prices and volatility increase across commodities, where the rise is due to fundamentals, discretionary managers who are expert in their sector, with a deep understanding of both the fundamentals and technicals, will benefit most.

Again, according to the managers we talk to, energy, industrial metals, precious metals, and agricultural commodities tend to have favorable fundamentals. Specifically some mention fertilizer, feedgrains, meats, iron ore, and carbon.

Some argue it is impossible to determine "fair value" for a commodity because there is no cash flow to discount like with stocks or bonds, but that the fair value of a commodity is simply the price someone is willing to pay for it. However, many think oil and gold look to have become overvalued, certainly in the short term and possibly over the longer term as well. Apparently Saudis produce oil for $6 a barrel, but the oil is being priced off marginal supplies such as the Canadian oil sands plus about $20 of speculation. Presumably, the world has about a 40-year supply of oil, but we will figure out how to get solar energy and store it before then.

Increased investor interest in commodities over the last few years has altered the shape of some commodity futures price curves, generally leading to more contango. This works against both passive indices and systematic long-only trading strategies from the negative roll yield associated with being long futures curves in contango. These programs also face trouble as shifting curve shapes imperil systematic strategies based on historical curve shapes. However, systematic trading programs that are active long/short have the ability to account for relative value as well as basis risk. Most of these programs turn in under eighty days so they respond to fundamental changes quickly and are best at cycling through the commodities of the moment.

Till: A big point is that in a commodity bull market it is very challenging for any discretionary program to outperform, on an absolute-return basis, a well-designed commodity index.

If a fundamental program is based on historical relationships, then the current market environment has not been a favorable one for that type of analysis. That said, there are a handful of fundamentally-based commodity hedge fund managers who have been able to successfully navigate the structural breaks of the last 3 years and have put in stellar returns.

Regarding systematic trading programs, NewEdge's Alternative Investments Group calculates the returns to following various momentum rules across asset classes. As of 4/17/08, the returns from investing in commodity futures based on a 240-day breakout rule have been 35% during the past year, so a relatively simple, technically based system would have put one in good stead, too.

Q: Futures and options have historically been the most prevalent instruments employed to trade commodities. Over the past couple of years, however, there have been a number of commodity-linked structured products and exchange traded funds that allow participation in these markets. To what degree have these new structures been added to the mix of instruments used by professional asset managers? Are there any inherent inefficiencies within these structures that make them attractive? Unattractive?

Barrack: Asset managers have still largely used indices for their commodity investments. Some of these indices have perceived floors that many newer products have aimed to expose and outperform. There has been a general move towards such out performance products recently which revolve mainly around the rolling methodology of the futures contracts. The basic premise is that with the weight of money in the indices, there will be more optimal times to roll the long futures contracts so as not to trip over the masses who are rolling on the pre-specified roll days that the rest of the market is aware of.

There has also been a large growth in the structured products market, but the investors have been high net worth in nature as opposed to asset managers. The standard and most popular structured product is the Principal Protected Note. They give participation over a basket of commodi-

ties (a subset of the number of commodities in an index). They also give exposure, not to the spot price of the commodity, but to the forward price of a commodity.

What makes such products attractive is their affordability. The majority are referencing commodities that are in "backwardation" where the forward price is lower than the spot price. Also the volatility of forward prices is generally lower than spot prices in commodities, adding to a cheapening of the option that is embedded into the structured note.

When comparing the performance of such products versus an index product where the spot returns are tracked, it really comes down to how forward versus spot prices perform. Generally, in commodity markets, the spot price will appreciate faster than the forward prices in a bull market, as short term supply issues are usually driving the price. However, in the current bull market, we have seen the long run fundamental supply concerns being a large driver of prices in, say, the crude oil market, so forward prices have at times outperformed the spot prices.

In general, such products have performed well in the commodity markets over recent years, and for investors who are used to buying principal protected notes, they offer a large amount of comfort in that their principal is protected in markets that are notorious for being volatile.

Cole: As far as structuring goes, I don't think there is anything "new" for the commodities investor that we have not seen before in other markets. Structured products, like guaranteed funds or commodity linked notes, are usually a convenience product for end users, and there is usually a high fee charged for this "packaging factor". But for the traders, futures exchanges have always been a great way to minimize counterparty and credit risk. Customized exchange clearing contracts offered by The Intercontinental Exchange (ICE) and Clearport (NYFE) are great, and these are thriving markets; and other exchanges are evolving as well in order to grab market share from the OTC and bank market.

Gunzberg: Retail investors have accounted for most of the use of the commodity-linked structured products and exchange traded funds (ETFs.) However, there seems to be some use of ETFs among institutional investors as a way of diversifying exposure by buying long as an investment and selling short as a hedge.

These products have some beneficial features to individual investors because they are tradable in smaller lots, have no daily settlement requirements, and have no inherent leverage component. They also offer tax advantages for retail investors that would not otherwise be available to them in commodity space. The only directly observable benefits to institutional investors would be possible extra diversification or high liquidity. However, the participation by retail investors with little to no understanding of commodity market fundamentals may artificially affect the supply and demand, which could create a trading opportunity for institutions.

The structured products are generally expensive with several potentially unattractive features to institutional managers. Namely, there are defined obligations with regard to maturity (e.g. a capital guarantee product typically applies only if the product is held until maturity), liquidity issues, fees, mark to model risk, transparency, and counterparty risk. Additionally, they tend to be concentrated, long in nature, and passive. Lastly, ETFs that invest in commodity-related equities are a particularly elliptical way of participating in commodities because companies often have economic characteristics that interfere with profiting from changes in the commodities with which they are directly associated.

Till: In the current credit environment, one should take care that one is comfortable with the credit risk of the issuers of commodity-linked structured notes, and that one is adequately compensated for taking that credit risk.

Q: Another angle for gaining natural resources exposure is by investing in public companies that derive a majority of their revenues from the commodities markets (e.g., oil services, mining, and storage companies). What are the advantages and disadvantage to this type of exposure? Are general equity market correlations a concern, or do these types of stocks offer significant diversification? Are there any attractive public debt, private equity, and/or private debt situations offered by these types of companies?

Barrack: The largest disadvantage to investing in commodity equities is that the company can underperform due to poor management or hedging strategies in the face of rising commodity prices. Over the last 3 to 4 years, though, producing companies have been urged by shareholders to hedge less for the reason that investors are looking for commodity exposure from their investment.

The largest advantage to investing in commodity equities will come from the participation in both the potential upswing in commodity prices and the potential upswing

in equity markets. This was true for the period up to July of last year when the equity market came unglued. Now we are in a period where the company specifics and financial soundness of the company is all-important again. Having access to the credit markets to expand or finance production in current conditions is putting stress on many commodity based companies.

The availability of private equity and debt offerings in the market is scarce, and for quality projects even more so. The amount of money pouring into the commodity sector will keep the returns low and the risk high, as most participants are blind to the intricacies of commodity markets.

Cole: Global private equity and debt for both sovereign and commercial concerns are thriving, much of it infrastructure and technology focused. But a disadvantage in these private transactions might be long multi-year lockups. In the more liquid public equities markets, we have seen huge growth of hedge funds that have a "natural resources" focus: energy, water, mining, shipping, MLPs, etc. The advantages to combining equity based strategies with the futures managers is that it adds to your opportunity set and adds diversification to your commodity investing strategy. But adding equities to the investor's overall portfolio mix may increase their correlations to the broader equity indices.

Gunzberg: While natural resource company stocks and their underlying natural resources may not be perfectly correlated, these companies cannot completely disconnect from their fundamentals. These companies have earnings, potentially high profit margins, dividends, and P/E expansion when rates rise (which is contrary to the behavior of most other equities). Moreover, companies have a franchise value that will limit the loss on a stock. Also, natural resource companies are not subject to the contango or funding cost issue which has intensified in commodity futures in past few years. Lastly, there may be stocks available for purchase where there is no futures contract associated with the commodity.

There is concern of general equity market correlations to natural resource company stocks, especially when there is a market collapse from a negative event like Bear Stearns. This also applies to global markets. For example, last year a manager sold its exposure to a Chinese dairy company whose stock had tripled in price. While the bullish case for milk prices remains in place even today, the stock plummeted along with the rest of the Chinese stock market. That said, natural resource stocks can offer diversification benefits when used wisely as a substitute for or complement to commodity futures exposure. As mentioned in the above question, there may be equities that give access to exposure where there is no associated futures contract.

Generally, the debt is not the most opportunistic way of getting exposure to commodities because the bonds only pay around a 6% coupon. However, almost all of the companies, public and private, have debt offerings.

Till: According to a recent research report by UBS, the stock prices of the major US oil companies are still discounting only a $58 per barrel long-term price for oil, so one has a margin of safety when investing in oil companies as compared to oil futures contracts, assuming that windfall profit taxes are not imposed on oil companies.

In a structurally higher priced energy market, one has to start thinking about what the fundamental economic consequences of this change will be. One consequence may be reduced reliance on trucking in the U.S. It is notable that Warren Buffet started investing in railroad companies last year.

Another way of obtaining exposure to commodities is through a natural resources fund of funds. Funds of funds can potentially diversify away the idiosyncratic, operational risk of an individual commodity hedge fund (or futures trading firm), both of which are frequently boutique in nature.

Q: Historically, within the context of any perceived asset "bubble", there always tends to be an influx of managers who ride the wave, garnering outsized returns with primarily unhedged strategies. Not surprisingly, most of these managers get carried out on a stretcher when the bubble finally bursts. In your opinion, do you believe commodities are in danger of entering bubble proportions at this time? In you estimation, are there a lot of players riding this wave without much attention to hedging and risk management? How susceptible might the entire commodity sub sector be to a downturn and mass liquidations?

Barrack: The world believed that the commodity bubble had burst when crude oil fell from its highs of over $80 per barrel to below $50 in January 2007. With crude oil now trading at new highs of over $118 per barrel, and Russia talking of having gone through peak supply, and demand still going strong, we doubt that the commodity markets have yet reached bubble proportions. The current commodity boom is long-term in nature, as on the one hand we have strong resource-intensive growth in Asia,

and on the other, we have structural constraints to supply (declining oil reserves, rising costs, lack of skilled labour, land availability and environmental issues). China has entered long-term supply deals around the world, suggesting that their spectacular commodity demand still has far to go. And India will follow the same path in due course – extending the bull run further.

There can be no doubt that commodities are attracting unprecedented attention from investors and traders. Will some of these get their fingers burnt? Of course. Commodities are a volatile asset class that requires both a sound fundamental understanding and a long history of involvement. The latter point is important for hedge funds specifically, as there are many traders who have only participated in these markets for the last 5 years and hence only know how commodities trade in a bull market. It is important to remember that the largest short term price moves in commodity prices are generally when they fall. Take crude oil, for example, that fell 40% in January 1991 in just 2 days following the expulsion of Iraqi troops from Kuwait. How would most investors fare under this scenario? Are the types of funds or investments protected with risk management strategies to protect against such an event? Unlikely.

We saw a large scale wash out of all markets in March this year. It was only then that investors and traders realized the potential correlation effects across their portfolios as all commodities and equities plummeted in unison. However, this downturn was short lived. Commodity prices quickly recovered and many traded to new highs in short order. The reason is that the fundamental supply imbalances across the majority of commodities continue to support and inflate prices and will do so for the foreseeable future.

Cole: If there is a bubble and a crash, I think it's best to ride it out with a portfolio of professionally managed hedge funds and CTAs. Our universe of commodities (futures on physicals) focused CTAs and hedge funds contains less than 500 managers representing an estimated $70 billion. This does not account for the mega multi-strategy hedge funds, prop desks, or unregistered futures traders that are not directly answerable to their investors for their commodities P&L. And while this sector is growing pretty rapidly, it's still very small in relation to the broad hedge fund universe. And it pays to note that in contrast to many traditional equities or fixed income funds out there, many of the commodities managers we have seen use relatively low amounts of leverage because the volatility is very high and the markets are still pretty inefficient.

So back to the bubble, it's hard to say, but if you look at the CRB, inflation adjusted prices are still pretty low compared to the peak in the 70s (except for oil which is at new all time highs), and inflation is still pretty low. But bubble or not, these markets are extremely volatile and subject to major cyclicality where mini boom/bust cycles can lead to 50-70% price moves in a 12 month period. So boom or bust, it's going to be a volatile sector, so the best common denominator is to have a disciplined, consistent approach to risk management.

Gunzberg: The asset class has attracted a number of participants new to commodity investing because it is one of a select few to have generated positive returns lately besides T-bills. While there are characteristics currently in the commodity sector similar to those of other sectors that have experienced speculative bubbles, there are undeniably strong fundamentals driving growth. The long-term fundamentals both for rapid Asian growth and elevated demand for raw materials are favorable, but short-term excesses appear to have arisen in the energy and precious metals market, perhaps in foodstuffs markets as well. Some of this pressure has been relieved with the deleveraging events that impacted all sectors in March. Additional outflows should occur with recoveries in the other major asset classes followed by a clearing out of participants after the commodities markets experience a significant downdraft.

Yes, many nontraditional players were attracted to commodities, particularly in the first quarter of 2008 due to perceived safe haven properties, and they had no regard for fundamentals or hedging and risk management. Experienced managers should expect these short-term cyclical uncertainties and be effective and disciplined risk managers. In turn, the managers who are aware of the technical pressures from flows should be able to monetize these inefficiencies. Leveraged market participants are most susceptible to near-term "corrections" in commodity price trends and to mass liquidations. Again, given the strong fundamentals, it is unlikely the entire commodity subsector is at risk, but specific subsectors might be. The highest probability for a downturn of the entire commodity subsector with mass liquidations would be if supply were to catch up with demand. Some predict that could happen as early as 2012.

Till: Many experienced traders have noted how ephemeral trading strategies are, or at least, how all

strategies have life cycles: "Just when you think you found the key to the market, they change the locks," declared the late Gerald Loeb, who was a highly successful financier and founding partner of E.F. Hutton, as quoted in a recent UBS commentary.

At my firm, we have long accepted that individual trading strategies cannot be expected to be enduring. But we do believe one's risk management methodology can be enduring instead.

Since the spring of 2006, the choice of leverage level for a commodity futures program has become more difficult, given the periodic bouts of de-risking and deleveraging that have occurred as the commodity markets have become more correlated with other risk assets, at least over short time horizons.

Commodities were clearly not immune from sharp episodes of widespread deleveraging of risky investments during the past two years, as occurred during May and June of 2006, the end of February 2007, and again in mid-August 2007.

During the May/June 2006 deleveraging of risky investments, for example, commodities appeared to become the same trade along with other risk assets. In observing this correlation, one might temper the amount of leverage applied to long commodity trades, or include other assets in the portfolio that would be expected to do well during any deleveraging. That said, the risk in the current environment may be more about being careful about the solvency of one's counterparties rather than about being concerned about future episodes of de-risking and deleveraging.

Another example of simultaneous deleveraging is from February 27, 2007. At the end of the trading day, market participants saw algorithmic strategies simultaneously deleverage across numerous risky investments, including in popular commodity plays. In this unusual environment, the normally illiquid platinum market was more liquid than the gold futures market, as leveraged participants rapidly tried to simultaneously unwind gold positions.

This phenomenon again became of concern on August 16, 2007, the day before the Federal Reserve Board cut the discount rate. On that date, all commodity markets in the Dow Jones AIG Commodity Index were down, along with all other risky assets. The next day, after the announcement of the Fed's action, most risk assets simultaneously rallied, including commodities.

Interestingly, one exception to the "global unwind" of the time was petroleum complex refining margins, which were underpinned by relatively low product inventories, particularly in gasoline.

During the week of March 17, 2008, market participants appeared to embrace a "preservation-of-capital" stance in the aftermath of the near collapse of Bear Stearns. Not only did three-month U.S. Treasury Bills (T-Bills) hit a nadir of 39 bps in (annualized) yield, but the commodity markets witnessed a weekly sell-off, the scale of which had not been seen since 1956.

These scenarios illustrate that, at least over the short term, commodities are susceptible to downturns related to the overall risk environment. ◊

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