Investors square up for a food fight

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Supply and price of food have become big issues around the world and these concerns are now attracting the attention of investors wondering if they can make money from these trends.

Russia has banned exports of wheat after widespread wildfires, caused by a blazing hot summer, damaged the harvest. In Mozambique, a 30 per cent rise in the price of bread has sparked riots, leaving 13 people dead.

That much is clear from the growth in the number of funds being launched that invest, directly or indirectly, in agricultural and ‘soft’ commodities. BlackRock, Sarasin, Baring and Thames River have launched agriculture-related funds in recent years.

ETF Securities runs 50 agriculture and livestock exchange traded funds and commodities. These track particular indices and the underlying commodities themselves. They can be bought and sold like shares, and offer investors exposure to everything from a general commodity index – such as the Dow Jones UBS Agriculture sub-index – to cotton. Its broad agricultural ETF is the third biggest in terms of funds under management.

There are three main reasons for the surge in interest in agricultural commodities – Jonathan Blake, manager of the Baring Global Agriculture fund, calls them the three ‘F’s: food, feed and fuel.

First, there will be a lot more mouths to feed in future as the world’s population rises from the current 6.7 billion to a projected 9.1 billion by 2050. Second, as people become wealthier, they will consume more meat and other proteins.

Henry Boucher, manager of Sarasin’s AgriSar fund, points out that the average spend on food in France, the highest-spending country, is $3,000 (£1,883) per person per year; in China, it is $300. ‘The Chinese are increasing their consumption rapidly as their standard of living rises,’ says Boucher.

Demand for protein will increase demand for agricultural products, as eight kilograms of feed is required to produce one kilogram of meat protein, according to Baring’s Blake.

Third, biofuels are increasingly being used as an alternative to fossil fuels. The US plans to produce 35 billion gallons of biofuels by 2020. That will increase demand for the corn, sugar and rapeseed oil used to produce these fuels. ‘A third of the US corn crop is already earmarked for producing bioethanol,’ says Blake.
Recently, a fourth factor has become significant. Although the long-term effects of climate change are yet to be established, global weather patterns are becoming more erratic, making crop production increasingly unpredictable.

Paradoxically, these four factors are not yet having much impact on the price of agricultural commodities themselves. While some commodity prices were hitting record highs in recent months, the long-term picture is not particularly exciting.

Martin Arnold, senior analyst at ETF Securities, says the Dow Jones UBS Agriculture sub-index has risen just 6 per cent over the past decade. It is ahead of the S&P 500, which is down 15 per cent, but behind the 8 per cent rise in the FTSE 100.

While individual commodities may have done better over some periods, their performance has been erratic.

‘Agriculture prices across the board tend to react quite quickly to changes in supply. Softs often trade in a range for a long time. Then there will be a sharp increase followed by retrenchment,’ Arnold says.

‘Investors look at agriculture as a way of diversifying their portfolios.’

The volatility of commodity prices means that most agricultural funds choose not to invest in commodities themselves but in the shares of companies that will benefit from the four long-term trends outlined.

Richard Davis, manager of the BGF World Agriculture fund, says agricultural commodities are different from commodities such as oil and base metals, where higher demand generally leads to higher prices.

‘Agriculture is different,’ he says. ‘Producers can grow more crops, and use better seed and more fertiliser to boost yields. An upturn in commodity prices can be short-lived.’

Davis’s fund invests in quoted farming businesses, fertiliser suppliers, as well as palm oil and biofuel producers. Some of these companies’ shares will be heavily influenced by commodity prices. Demand for fertiliser, for example, will rise as farmers foresee higher prices for their wheat and other products, boosting the shares of fertiliser producers.

Davis says: ‘Some equities perform better at different points in the cycle. For example, if there is a bumper harvest, it will not necessarily be good for commodity prices. But it will be good for companies that handle the crops.’

Some companies, such as tractor maker John Deere and fertiliser manufacturer Potash Corporation, which is currently the subject of a bid from BHP Billiton, crop up in many agriculture funds.

Among Blake’s favourites are food processors such as Archer Daniels, which converts a range of crops into food and fuel. Crop yields have been increasing globally over the past 40 to 50 years because of the use of better-quality seeds and fertilisers, but Blake points out: ‘In emerging economies, there has been a pattern of declining yields because of a lack of investment in the industry, over-farming and poor farming technique.

‘The increase in the population in emerging economies could be an incentive to invest in agriculture.’

Boucher says his fund goes from ‘farm to fork’. He does not just consider the direct beneficiaries of commodity demand: ‘We look at who benefits from this trend. Farmers will have more money in their pockets, so they will buy things like tractors.’

He is less enthusiastic about fertilisers which, he says, ‘are like a warrant on the crop price’. He points out that hedge funds own fertiliser stocks as a geared play on commodity prices. ‘We see it as a component of [an agricultural fund], but it shouldn’t be a big part and it should be managed carefully.’
he says.

Speculation by hedge funds or other investors is becoming an important part of the commodity market.

In a paper issued in September, the UN's special rapporteur on food, Olivier De Schutter, blamed a 'speculative bubble' for rising food prices.

He believes commodities started to see big speculative inflows from 2001 onwards. 'Other markets dried up one by one: the dotcoms vanished at the end of 2001, the stock market soon after and the US housing market in August 2007,' he explains. 'As each bubble burst, large institutional investors moved into other markets. Strong similarities can be seen in the price behaviour of food commodities and gold.'

Simon James, a partner at Gore Browne Investment Management, says there is undoubtedly speculation in the agricultural commodities markets, as there is with gold, but the long-term trend towards higher demand is undeniable.

He favours agriculture funds that invest in production, plumping for Eclectica Agriculture Fund, which concentrates more on the production side of the industry, and Thames River Water and Agriculture Absolute Return fund, because it also gives exposure to water, which can be difficult to achieve through any other vehicle.

Adrian Lowcock, senior investment adviser at Bestinvest, thinks private investors should think carefully before they get involved directly in soft commodities.

'With the expectation that the growing population will drive up the price of soft commodities, many people think that this is a one-way ticket. However, the supermarkets have kept prices down in recent years and technology and innovation could do the same.

'It may be better to look to companies that invest in the markets, and not the underlying commodity, to make a return on your investment.'

A mixed record for agriculture funds

The performance of agriculture funds has been mixed: Eclectica’s fund is up 15.4 per cent over one year, compared with a 9.9 per cent rise in the MSCI World index. But in the three years since it was launched, it is down 8.5 per cent, compared with a rise of 0.1 per cent in the index. Sarasin’s AgriSar is up 17.5 per cent over the past year, Barings' fund has produced the same return, while Thames River’s fund is up 3.7 per cent since it launched in the spring of 2009.

The arguments for long-term growth in the commodity market are persuasive, but none of the agriculture funds have long enough track records to establish whether this growth trend really will produce better returns from agriculture companies or, just as important, whether fund managers have the demonstrable skills to pick winners.

Simon James thinks it would be prudent of investors to have a small part of their portfolio in this area as a diversification but that it should be limited to between 5 and 10 per cent.