



**P**alak is a relatively new member of Principal's staff and sits on the Directly Invested team. She brings with her a solid background of investment experience and qualifications. Joining us over 5 months ago, she works closely alongside our Head of UK Equities and frequent PIMview contributor, Richard Champion. She is a vivacious addition to the team and we look forward to hearing more from her in the future.

palak.patel@pimltd.co.uk



Principal  
Investment  
Management  
Limited  
**Profitable  
know-how**

www.principalinvestment.co.uk

**Palak Patel CFA  
Investment Manager**

With over 7 years' investment experience, Palak was formerly an Associate Director at UBS where she worked as a multi asset class Investment Manager, specialising in UK and European Equities for high net worth private clients. Prior to that she was a Portfolio Adviser at Coutts & Co. Palak is a CFA charterholder and a member of the UK Society of Investment Professionals. She is a graduate of Kings College, University of London with a BSc (Hons) in Mathematics and Management. She is based in our London office.



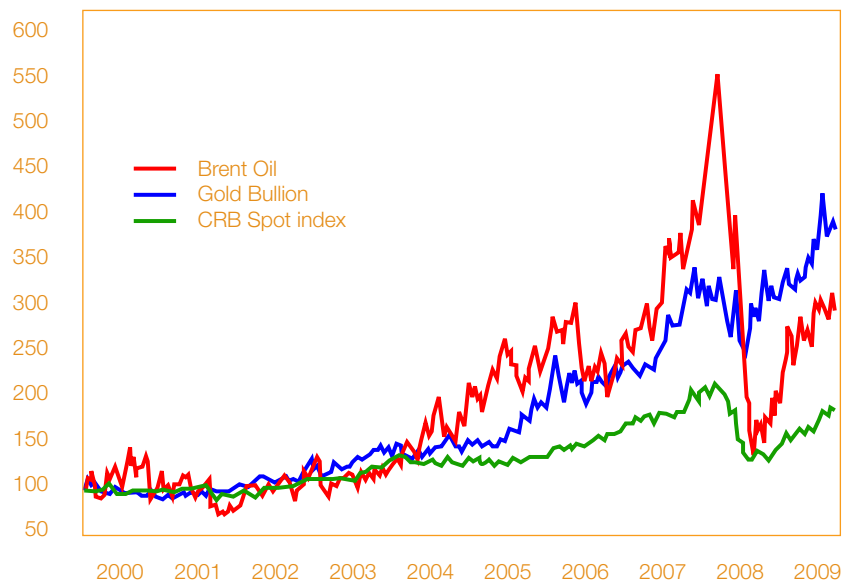
## Concerning Commodities

Over recent months commodities, particularly oil and gold, have captured the imagination of many investors. It seems to us that this elevated interest stems from three broad concerns:

- 1) capturing the benefits of diversification in order to lower portfolio volatility;
- 2) protecting wealth from potentially higher inflation;
- 3) positioning to take advantage of recovering global growth, particularly in the emerging markets.

Within this edition of PIMview, we would like to offer our thoughts on these areas, focussing on oil and gold. These are two of the most hotly debated commodities at present, with some investors questioning how close we are to reaching peak production levels and whether any increased demand will push prices higher still.

**Commodities**  
(All returns rebased to 100)



Source: Thomson Datastream

## The diversification benefits

The turmoil in financial markets over the last two years has scarred investors and left them keen to reassess the risks inherent in their portfolios. One way to improve the risk-adjusted returns would be by increasing portfolio diversification.

Analysis of historical returns confirms that commodities have provided downside protection in past market dislocations, such as the oil crisis in 1973/74. However, this is not always the case. During the most recent financial crisis, asset class correlations actually *converged*, reducing the diversification benefits of having multi asset class portfolios. With respect to commodities specifically, the 12-month rolling correlation with equities reached a high of 0.76 in August 2009 (according to Goldman Sachs). As the extreme levels of risk aversion that characterised markets at the end of 2008 dissipate and fundamentals once again became the primary drivers of asset returns, correlations between asset classes have begun to weaken.

One popular way to invest in commodities is using Exchange Traded Funds, which are based on futures contracts. The problem with this strategy is that the costs of managing the underlying futures can be highly detrimental to performance.

We prefer to gain exposure to commodities through equities. Although commodity-related stock returns are affected by equity market risk and idiosyncratic risk, their exposure to the underlying commodity prices is significant. Taking the oil and energy sector as an example, a recent analysis conducted by Goldman Sachs on US equities stated that nearly a third of the investment return of the shares was due to movements in the underlying commodities.

## Commodities as an inflation hedge

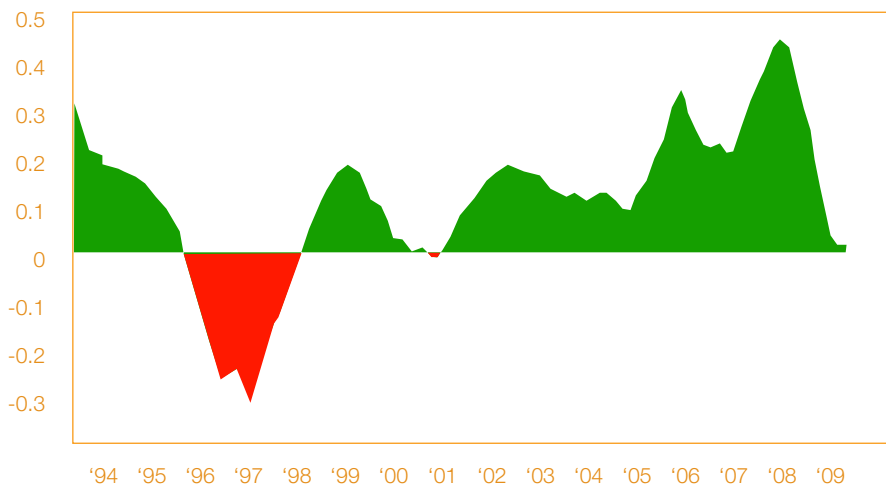
In the UK, recently reported inflation numbers, based on December data, came in above consensus expectations, driven by higher energy costs and the weakness of sterling. With CPI at 2.9% year on year, the Bank of England is very close to exceeding its inflation target. Going forward, in addition to rising energy bills, increases in indirect taxes (such as with VAT in the UK) are expected to push inflation markedly higher over the first half of 2010. This, combined with concerns about the removal of the monetary policy stimulus put in place last year, has left investors seeking for ways to hedge their portfolios and, amongst other things, resorting to investing in commodities such as gold.



We recognise these relatively short-term inflationary pressures but feel that over the longer term inflation is likely to remain subdued given excess capacity in product and labour markets, suggesting that income formation and pricing power will be slow to recover. Nonetheless, to hedge against potentially higher inflation in the near term, we recommend inflation-linked gilts rather than gold or other commodities, as we do not believe these assets offer sufficiently reliable protection.

Real industrial commodity prices have actually fallen over the past 140 years, returning -0.4% annualised. Similarly, real agricultural commodity prices have returned -2.1% annualised since 1947. Oil has outperformed inflation since 1947 by 2.6% annualised but this was driven by the two oil shocks of the 1970s and 1980s. Since 1980, oil prices have actually lagged inflation by about 1% a year. Although gold has also exceeded inflation by 0.9% a year since 1871, this out-performance becomes negligible when the last four years of very strong returns are stripped out. The chart below shows that the correlation between gold and inflation is just 0.018 on a monthly basis. We do not feel that this supports an investment case for gold as an inflation hedge.

The Correlation Between Gold and US CPI



Source: Bloomberg

## Investing for growth

Economic recovery hopes in the Far East, notably China and India, which are net importers of commodities, have also fuelled the rise in commodity prices and related equities such as the miners. Commodity prices should continue to benefit from the continuing splurge in investment spending in these markets, implying strong demand for industrial metals and energy. The confirmation of the depth and durability of the developed world recovery would be taken as a further catalyst. However, we always have to balance this secular growth story with the valuations at which the underlying equities trade.

We view reflation in these emerging markets and industrial restocking in the developed world as positives for the demand for resources. We are cautiously optimistic about global growth and expect China and India to remain the principal drivers behind this growth.

Risks to our view remain, including a vulnerability to disappointing economic data after such strong gains already seen by commodity stocks. Investors should remain wary of the industrial production cycle, commodity stockpiles and the US dollar. Also, China has recently begun to tighten monetary policy earlier than expected; this could cause volatility in the short term.

Our preferred way to invest in this theme is therefore to use a combination of commodity-exposed equities and actively managed Far Eastern and Emerging Market funds. This provides a good spread of exposure to the themes involved without tying us too tightly to any individual commodity story.

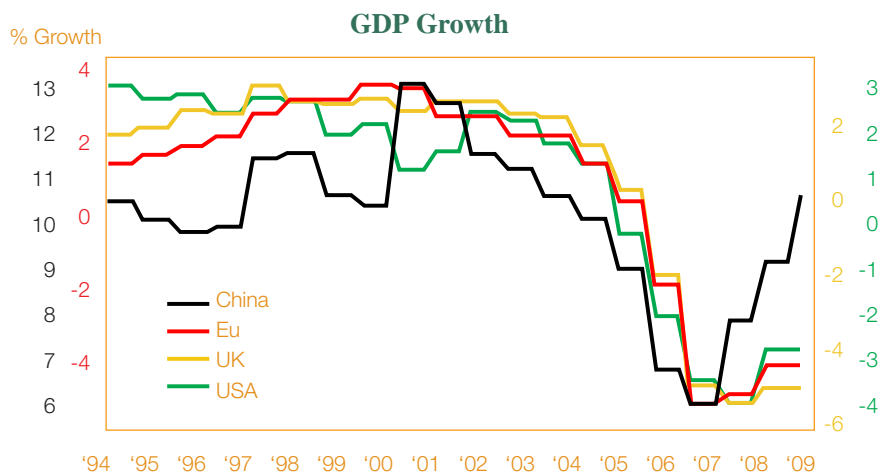
### Conclusions

We believe that commodities investments do offer diversification benefits over the long term but feel that we must take care to access these benefits in a way that is efficient. In addition, given our cautiously positive view on global growth, we also see commodities as one way to play the secular growth theme. However we do not think that commodities make an efficient hedge against inflation stoked by loose monetary policy: in this respect we prefer index-linked gilts.

Below is a summary of our outlook on oil and gold specifically. Although we expect demand from the Emerging Markets, the strength of the US dollar and inflation expectations to strongly influence commodity prices, we would add that forecasting returns is far from simple, as factors such as geopolitical uncertainty and market speculation also play a significant part.

### Oil

Crude oil prices have rallied significantly from their lows driven by the recovery in global growth, but consolidation is likely in the months ahead based on supply and demand forces. US



Source: Bloomberg

inventory levels are close to the top end of their five year range, whereas the demand is nearly 9% lower than its 5-year average. On a global scale, the OECD also have strong inventory levels covering close to 59.4 days of OECD consumption, compared to the 20-year high of 64.6 days. In our view, recovering global growth will bolster oil demand, but high inventories and increased production from non-OPEC countries, which surprised to the upside last year, will keep oil prices stable in the near term, barring any major geopolitical event.

Within the sector, we are wary of Exploration and Production (E&P) companies, given their relatively expensive valuations and higher leverage to the oil price. We believe capacity addition seen over the past few years will dampen earnings expansion for these companies. We prefer the Integrated companies which offer more stable earnings, an inexpensive valuation and a supportive dividend yield. Our preferred picks are currently BP and BG.

### Gold

The rally in gold, up 66% from 2008 lows, has been driven by concerns over inflation, the dollar and jewellery demand. Although we aren't comfortable with its hedging properties, inflation expectations have fuelled retail demand for gold, but we see this as very momentum driven.

The trend of central banks diversifying their reserves by adding to gold, particularly in the Emerging Markets, is supportive of the gold price - China added 450 tons over the last 5 years and India bought 200 tons from the IMF in late 2009. Although the proportion of Emerging Market reserves held in gold is increasing, the official sector, including central banks and multinational organisations, has been a net seller of gold for the last decade.

Over the longer term, jewellery demand will be supported by rising incomes and growing demand for luxury goods in the Emerging Markets. This structural theme seems to us to be the most persuasive argument for having exposure to gold, however our concerns about faltering jewellery demand at current prices and the growing amount of recycled gold dampening further price increases convinces us to wait for a pull back before investing in gold related equities.

# MARKET LEVELS AND MOVEMENTS TO 31 DECEMBER 2009

## UK Equities

	Index	vs Last Month %	YTD %
FTSE 100	5,413	4.3	22.1
FTSE 250	9,307	4.4	46.3
FTSE SmallCap	2,777	2.2	49.8
FTSE All Share	2,761	4.2	24.9

## Overseas Equities

	Index	vs Last Month %	YTD %	YTD (£) %
US (Dow Jones)	10,428	0.8	18.8	5.8
Europe*	147	5.0	27.0	17.1
Japan (Nikkei)	10,546	12.9	19.0	3.2
Pacific*	358	4.1	55.7	51.0

\*based on FTSE All-World Indices Europe ex UK and Pacific ex Japan respectively

## UK Valuation Yardsticks

Market P/E	19.0	(historic, FTSE All Share)
Index Linked Yield	0.7%	(over 5 years, 5% inflation)
Market Yield	3.2%	(net historic, FTSE All Share)
Base Rate	0.5%	

## Bond Yields

%	Now %	End 2008
UK	4.1	3.1
US	3.8	2.3
Germany	3.4	2.9
Japan	1.3	1.2

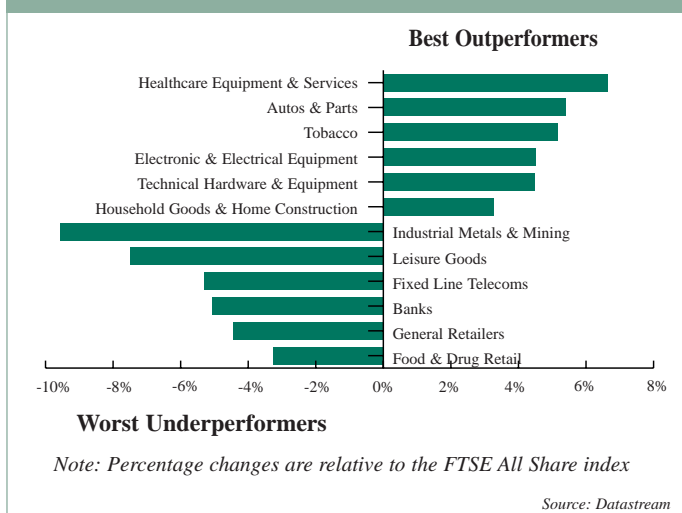
(based on ten year Government bonds)

## Currencies

	Current Rate	YTD %
£ vs US\$	1.6	12.3
£ vs Euro	1.1	8.8
£ vs Yen	150.3	15.3

Source: Datastream

## Sectors of the Month



## FTSE 100 Index



The views expressed above are based on information which we believe to be reliable but are not guaranteed as to accuracy or completeness by Principal Investment Management Limited. This document is not, and should not be construed as, an offer or the solicitation of any offer, or general or definitive advice to buy or sell any investments and any expressions of opinion are subject to change without notice. The value of investments, and the income from them, can go down as well as up. Past performance should not be seen as an indication of future performance.

If you have any comments or questions about any of the above, please email us at: [sales-support@pimltd.co.uk](mailto:sales-support@pimltd.co.uk)

[www.principalinvestment.co.uk](http://www.principalinvestment.co.uk)

### Sevenoaks

16 South Park  
Sevenoaks  
Kent TN13 1AN  
Tel: 01732 740700  
Registered and Head Office

### Bath

5 Miles's Buildings  
George Street  
Bath BA1 2QS  
Tel: 01225 460010

### London

Mansion Court  
25 Watling Street  
London EC4M 9BR  
Tel: 020 7367 9400