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listeningin

Hard Assets, Hard Analysis

Inflation Hedges In Commodities Need Active Strategies, Bialis Argues

As the Fed worried about deflation and readied QE2 for launch last week, the prices of corn spiked and cotton changed hands at prices not seen since the Civil War. If you detect a potentially enormous whiff of inflation, from ***Melanie Bialis****' perspective, well, you just might be catching on – slowly, but catching on at least. Melanie is the founder and chief executive of* ***Boxcar Capital Management.*** *The Santa Monica, CA based-firm runs a couple of commodities-focused hedge funds dedicated to the proposition that hard assets – especially those, as Melanie puts it, with utility – are the likely big beneficiaries of all of the money being pumped into the system – but that riding that wave will require employing active commodities strategies. Happily for her clients, Melanie has packed an awful lot of experience, primarily in managing commodities and futures, into her 12 years in the hedge fund industry—and it shows in her funds. They have racked up double and triple-digit gains over the last several years since inception, and Melanie is just getting warmed up. Listen in.*
KMW

You have been saying we should talk about investing in commodities for a while – and one lead story in the WSJ this week was about the grains surging, another about cotton breaking a record. Are we too late?

No, there's more excitement to come. One of the interesting things about the grains is how erratic and volatile the trading can be. Yet the grains have been one area this year where the price actually has moved based on supply and demand.

How strange!

Absolutely. A real anomaly. But there have been a number of factors coming together for several years to produce this uptrend. Back in early 2008, there was a flurry of concern about food inflation – remember **Costco** limiting customers to buying just one bag of rice? But that was quickly alleviated by the sharp drops in the prices of all commodities in the financial crisis. Well, I think that is going to turn out to be an example of a big correction in commodities actually being bullish for the long term. Current stocks in some of the grains,

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especially corn, are incredibly low – the U.S. corn stocks-to-use ratio is projected to fall to 6.7%, the lowest since 1995-'96. Starting last year, the USDA basically had been predicting corn yields for 2010 coming in at perfection. So they have been scaling back, in every report they have issued this year, their estimates of what they think grain yields are going to be. Last Friday [Oct. 8], they decreased their corn yield estimate significantly, from 162.5 to 155.8 bushels an acre, which came as a big shock to the market. I believe it was the biggest revision since 1995.

Is this like the oil industry or mortgage banking, when we find out only after the fact that the inspectors were asleep at the switch?

It's interesting. I suspect it's more of a situation where the USDA didn't want to come out immediately and say, "Wow, earlier we were really just projecting based on last year. But we were way off the mark." Instead, they're making this a slow bleed; coming out with revisions every time they publish a report. And this was a big one. It seems like the numbers will continue to point to lower and lower stocks and, potentially, lower yields. So we're now having these fairly large moves in the grains. Friday was a limit-up day across the board – and that is despite the fact that we aren't having a major weather disruption. If we have a major weather disruption, we're really going to be in trouble. Prices could go *a lot* higher.

Yikes. But before we go too far down that road, let's establish your *bona fides.*

You mean, how someone with a psych degree from NYU ended up running a couple of commodities-focused funds? I actually started out as a healthcare equities analyst out of school, working at hedge fund **Oracle Partners**, where a large focus of my job was identifying government policy changes and how they would impact trends within the healthcare services sector. **Larry Feinberg** at Oracle was really instrumental in helping me understand how macro events happening in Washington and policy changes would be absorbed by the markets – often in ways I would not have expected. That experience has been very helpful to me, for identifying trends in government policies and their impact on the global commodities, currencies, and bond markets, as well as on equities. Probably most importantly, Larry taught me that you have to pull yourself aside sometimes as an investor. You can't get caught up in whether the policy is right or wrong, whether or not it will happen, or how long you think it's going to stay around. The right question is how will it distort the markets? Ethanol is a good example. When the Energy Act was passed in 2007, I think a lot people said, "This is a terrible policy, so I'm not investing in any company, or in the grains, that will benefit from it." But they should have pushed that away and asked, "Are they really going to change this policy anytime soon?" And if not, looked for ways it would distort the markets. What I really learned at Oracle with Larry is that you have to focus on the variety of things that *can* happen not what *should* happen – and often markets can react in perverse ways.

"My overriding belief is that, long term, the dynamics are in place for a real need to own real assets – and commodities fit that bill."

I certainly won't argue that. How did you make the leap from Oracle to commodities?

Well, around 2002, I wanted a bit of change. My father, **Gary Bialis**, has been a commodities trader most of his life. So I went to work with him to learn a bit more about the futures business.

You do have a talent for understatement–

What should I say? We ran a managed account together for a while and then I decided I wanted to go off on my own. After running managed accounts for a couple of years, I launched Box Car Capital, my global macro fund, in late 2007, looking for long-term capital gains through exposure to commodities, currencies, and interest rate futures and options. A year later, I added Back 40 Capital, my long-biased commodities fund, to take advantage of what I see as bullish global trends in commodities markets.

"Box Car" and "Back 40"? Are you trying evoke the romance of hobos and America's agrarian past?
Well, "back 40" is a farmer term referring to an undeveloped plot of land on a farm (generally 40 acres) that the farmer can use for various crops or grazing. And a railroad boxcar used to be the most versatile means of transporting commodities, carrying everything from corn to iron ore.

You started Back 40 at the end of '08? Wasn't that quite a leap, in the midst of the financial crisis, when commodities prices were being savaged as institutional investors were violently disabused of notions that they had *diversified* in commodities?
Not really. That's where the appreciation for historical cycles in commodities that my father taught me proved invaluable. The second quarter of '08 was very tough quarter for me. My global macro fund was down 4% or so, because I was short commodities – a little early, obviously – and they were very much going against me. But what really struck me was that some of my investors weren't upset that I was down 4% that quarter; they really thought of me as a commodities manager and viewed their investments with me as an inflation hedge. That got me thinking about doing a long-biased commodities fund. Then, in the third quarter of '08, we clearly had a huge correction in the commodities space –

A wipeout, it's fair to say, which had most everybody swearing off risk in any form – making it a *very* unusual time to start up a new fund, especially in commodities.
Except, as I said, that I really benefited from my father's many years of experience, his having seen *many* cycles in these markets. He taught me the importance of historical research in commodities, which proved priceless when things happening in the commodities markets started unfolding similarly to how they did in the '30s. In fact, late 2008 saw the largest collapse in almost all of the commodities since the period of 1929 to 1932. Bad as the wipeout was, the one thing I found very interesting at the time was that commodities were one asset class that you very much could argue would *benefit*, long-term, from the credit crisis – from a supply and demand standpoint.

How so?
The markets had crashed just when the prices of some metals and energy were getting to levels where it was going to become economic to bring on new production. So all of a sudden, a lot of new production was taken off the drawing boards; a lot of new mines tabled. On the Ag side, farmers suddenly had difficulty accessing credit, so the usual supply constraints – heavy taxes, licensing, environmental, labor and equipment expenses – were made even worse. On the demand side, you had (and still have) the issue of central bank money printing, competitive currency devaluations and the potential for a rush to hard assets. Essentially, I decided that with prices representing very good value, on a long-term basis, and with the crisis acting as a long-term positive for both supply and demand dynamics, it was a good time to

start a long-biased commodities fund.

It didn't bother you that institutional fund flows were enormously negative at that juncture as the herd belatedly discovered that all correlations go to one, even on "passive" commodities, in a crisis?

Sure. This space is never safe when we have very correlated markets. You can look at 2008 and see that gold held up until it was sort of the last commodity standing, but when still more liquidity was needed, it had a very sharp selloff, too. But my overriding belief is that, long term, the dynamics are in place for a real need to own real assets – and commodities fit that bill.

You mentioned seeing a lot of similarities between 2008 and the Crash of '29 in commodities? Despite the enormous changes in the markets, and the world?

Yes. For instance, wheat, which (other than coffee) was the first commodity to top out in '08, was also the first one to signal big problems in '29 – after a crazy parabolic move up very much like the recent experience. There were all sorts of parallels in things like price technicals, too. The history just really seemed to be rhyming all these many years later. It didn't seem to matter if it was because there were so many passive investors in the market, as happened in '08, or because a lot of speculators were way overleveraged, as they were in the Crash. It just seems that when prices get so far out of whack, people flee for the exits. The details change, but human nature stays the same. In a sort of strange way, I found the steep correction in '08 comforting. One of the things I had always been nervous about before launching my firm was that I had only started in the commodities world in 2002, and so I had never lived through a major commodities correction. Then I did get to see one.

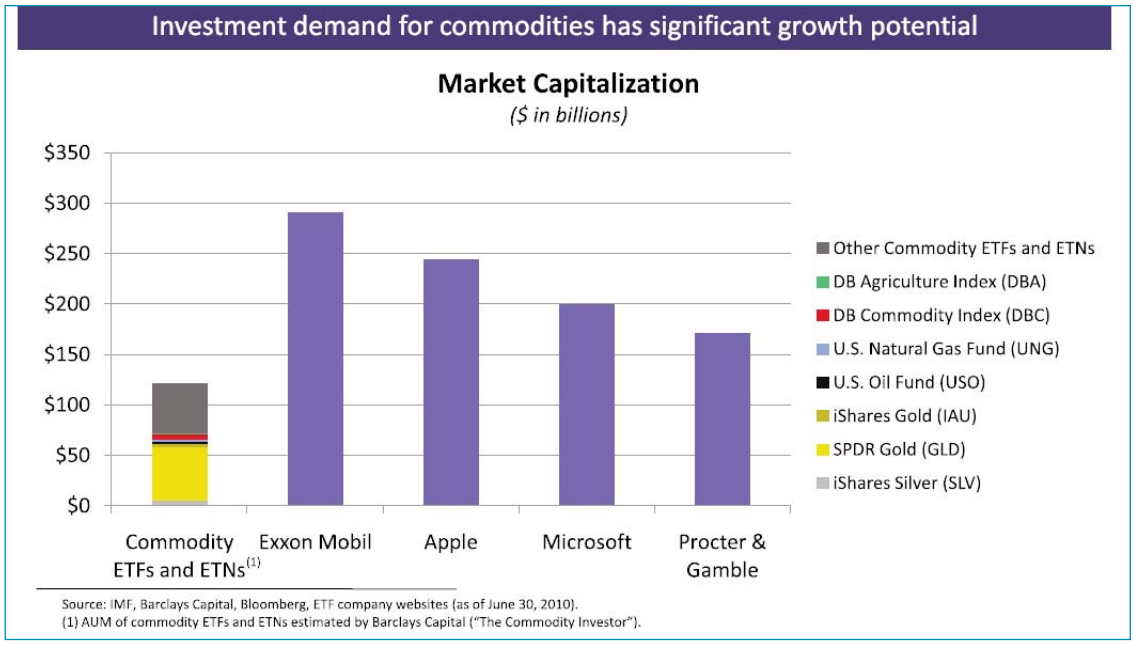
I'd file that under "Be careful what you wish for!"

I wouldn't say it was fun. But I do think volatility and corrections are a very important part of the business to understand. It was definitely a very good experience to get to see what 2008 had to offer. And when I did, knowing how to interpret what happened against market history, as my father taught me; sort of layering that on the technicals and the fundamentals, was very helpful in making me feel all right about buying commodities – some of them at very low prices, in late '08 – even though it seemed like the world was coming to an end. It really provided a buffer to me to be able to think, "Okay, we're not in as bad a shape as we were in the '29 to '32 period, and yet prices have collapsed by *more.* Also, we have all these potential demand drivers out there in these emerging markets that didn't exist back then."

And now? Your commodities fund is up over 100% over its short life, but your global macro fund has been struggling again this year. It's off around 4%, isn't it, even though it's still doing pretty okay, up over 30% since inception.

Global macro is frustrating again. I would argue that in 2008, there was this disconnect; you could see these problems in the system, but prices were slow to react. Once they did, though, it ended up being a very swift reaction! Currently, we're again seeing a lot of divergences where the prices actually don't appear to be following the fundamentals. And one of the big reasons, I would argue, is the government involvement. The disconnect you brought up between my commodities fund and my global macro fund reflects that. When you look at Treasury yields, they're forecasting deflation to some extent. But if you look at some of the commodities, the action has been incredibly inflationary. One of the indexes I look at is the CRB RIND index [see chart above]. It tracks commodities that are *not* traded in the futures markets, everything from butter to burlap, hides, tallow. It recently made a new high, *above* the 2008 highs. What's especially interesting to me is that in a lot of ways the CRB RIND is representative of real

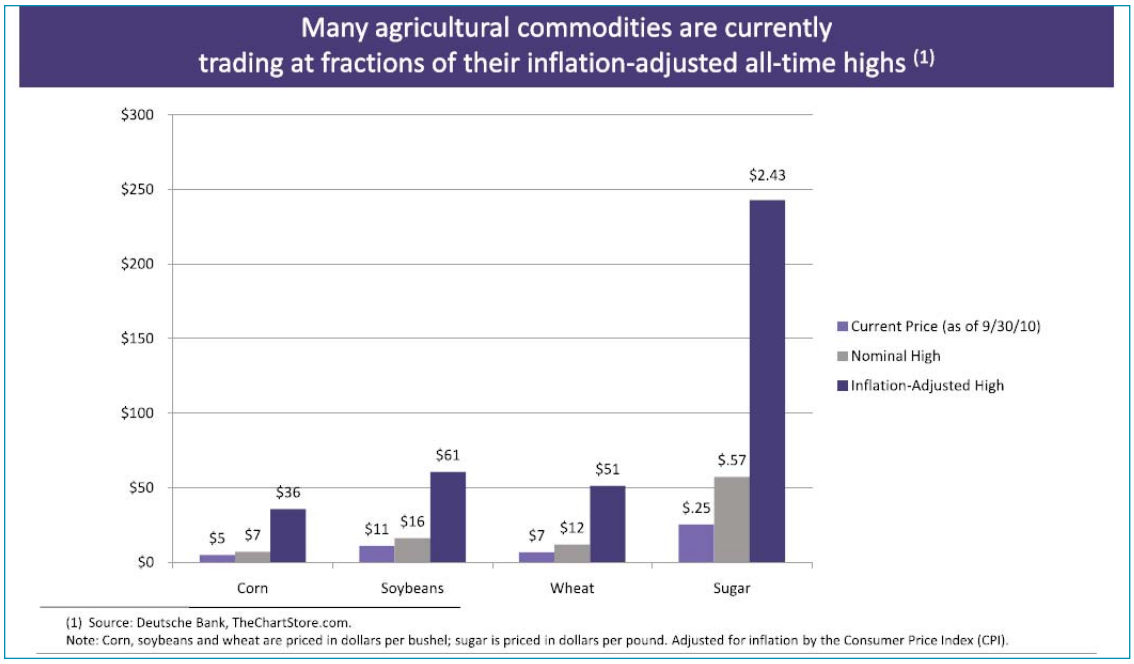
demand, because those commodities are traded in the real world, away from the futures markets and the swap markets that are being influenced by the passive funds and all of those things. So you really are seeing strong demand; what looks like inflationary signs in the commodities market. Yet you're seeing incredibly low yields on Treasuries, which are pointing towards deflation. Both can't be right and something is going to have to change.



You're betting, clearly, on inflation –
Yes, via real assets. It seems pretty clear to me, with sovereign debt soaring worldwide, political pressure is likely to lead to continued money printing – which means paper currency devaluation against real assets. The U.S. government, to cite the obvious example, has over $13.5 trillion of debt at last count, over 95% of GDP. Yet it is pursuing an unprecedented loose monetary policy, keeping Fed Funds at 0%-0.25% for an "extended period," – and from all indications is about to embark on QE2. Even without QE2, the Treasury and the Fed have already increased the monetary base by over 125% since the fall of 2008, a spike that may potentially translate into significant inflation over time. One of the issues for my macro fund, Boxcar, in the most recent quarter, was that a lot of the trends I have been expecting have not really materialized – yet. I expect real competitive currency devaluations as governments around the world attempt to push their currencies lower to compete in global export markets. It's been interesting to see a lot more in the press in the last couple of weeks about competitive currency devaluations and the rising price of gold.

The term "currency war" has even slipped from official lips. But the IMF had a big meeting a few days ago, and accomplished nothing, so what's new?
Exactly. What's interesting is that despite the increase *in talk* about currency wars and the rise in gold, one of the trends I have been expecting still hasn't materialized. Gold in the last couple of months has gone nowhere *in terms of euros, in terms of the Swiss franc, even in terms of the S&P or the CRB index*. It's actually lagging the euro at the moment, despite all the problems in Europe.

Why is that, do you think?
One of the issues is that fund flows seem to really be dominating the markets. The extra level of government involvement I think is creating flows as people swing from being excessively short the euro to overcompensating and going long; chasing yield wherever they can find it, rather than allowing the fundamentals to fall into place. We saw that with the euro in June. When there was much talk about the currency going under and all sorts of dire circumstances, the funds were incredibly short at 120. Now, they're long at 140, and the press seems much less focused on the euros' demise. But it's not all that much more off the boards than it was in June. It is just that attention has been shifted – and a similar thing could happen with this issue of a currency war. If not now, I expect that it *will* happen, as various countries struggle with how to deflate their currencies against each other in order to make themselves competitive. What this means is that there still is a lot of opportunity in gold. In '77 through '80, when gold had its preeminent bull market, it went up in terms of everything, the S&P, the euro – well, the euro wasn't around then, but it went up in terms of the d-mark, the Swiss franc, and all major currencies, as well as most com-



modities. But right now, despite all the talk about gold, it has under-performed the grains and some of the other commodities. So I think that there is still an opportunity in gold in terms of other currencies. We're not really in the midst of a currency war – yet – when we're not even seeing gold outperform the euro.

So we have that to look forward to?

We have that to look forward to. The question is how long that gets deferred. I do believe that *over a long period of time* gold will do well. There is an issue in that there aren't a lot of great alternatives to the dollar or the euro or the yen or the pound. So the fact that gold has not yet broken out against various currencies could mean two things: It could mean, as I said, that we're not quite at the dollar crisis that everyone thinks we're at, yet. But it could also mean that there's really a big opportunity in the precious metals, especially when you price them in currencies other than dollars. Now, I'm not a gold bug; I recognize that gold does have its issues. It's a very emotional metal and people trade it with emotion. Investment demand is overwhelming any real demand at these prices. Nonetheless, I do think there's a lot of room for increased investment demand in gold.

Even though money has absolutely poured into the gold ETFs and such?

Yes. One of the studies we have done [see chart, page 5] looked at the value of *all* of the commodities ETFs and ETNs in the U.S. and compared that to the market caps of just a couple of the large-cap stocks: **Exxon Mobil** (XOM), **Apple** (AAPL) and **Microsoft** (MSFT). As the chart shows, in the scheme of global markets, there's significant growth potential for investment demand in commodities. Just when stacked against the market cap of Exxon Mobil alone, the open interest in gold is fairly small. So there is a lot of room for the gold market to expand exponentially. But again, that does not mean that gold isn't subject to very emotional corrections. So as much as I think it's always important to own some gold, it's not enough. I also really want to own a basket of commodities that have *actual utility* – and gold is only worth what people think it's worth at any given time. At a certain price, gold sort of loses some of its utility as a commodity, because it becomes not as desirable in the jewelry market. It actually becomes more about investors than much else. By contrast, a basket of commodities, each with unique supply/demand drivers and varying sensitivities to the economy, can provide additional diversification benefits. In other words, a coffee position can stand on its own supply/demand fundamentals, regardless of whatever is driving the prices of copper or crude.

I suppose. But I have always found a certain irresistible utility in gold — necklaces, for instance—

But gold, at a certain price, sort of loses its utility, as it prices itself out of the jewelry market. Then it's more about investor demand and its role as an alternative to paper currencies than anything else. That said, what our [page five] chart does show is that we are *very* early in seeing investors move into gold. Gold, as a portion of people's portfolios is still quite small. If you think about how quickly the size of various markets has exploded – and I'm not saying this is necessarily going to happen to the gold market– but look at CDSs exploding. What did that turn into? A $62 trillion market, very quickly. It was $900 billion in 2000 and $62 trillion in

2007. In other words, we're a long way from any true gold mania right now. So both gold and commodities with utility provide some protection from a world in which none of the major currencies is attractive.

So which do you like better here, gold or the recently surging grains you started this interview enthusing about? There is no argument that grains are commodities with utility, as you say.

I'm more focused on the Ag side here, because it makes a lot more sense to me. There really is a supply/demand picture which is playing out; the surge in grains is much less about funds flow pushing prices up. Inflation-adjusted, agricultural prices are incredibly low, much lower than other commodities. They have a lot of room to go up and I think the demand is there. As you can see in our chart [opposite], both the nominal prices and the inflation-adjusted prices of corn, soybeans, wheat and sugar, are currently just fractions of their highs. Sugar is particularly extreme in that regard, because even in nominal terms, its high was 57 cents – and that was not in 2008. It was in 1974 – and now it trades around 25 cents. In inflation-adjusted terms, that sugar high was $2.43.

Which is more attractive here?

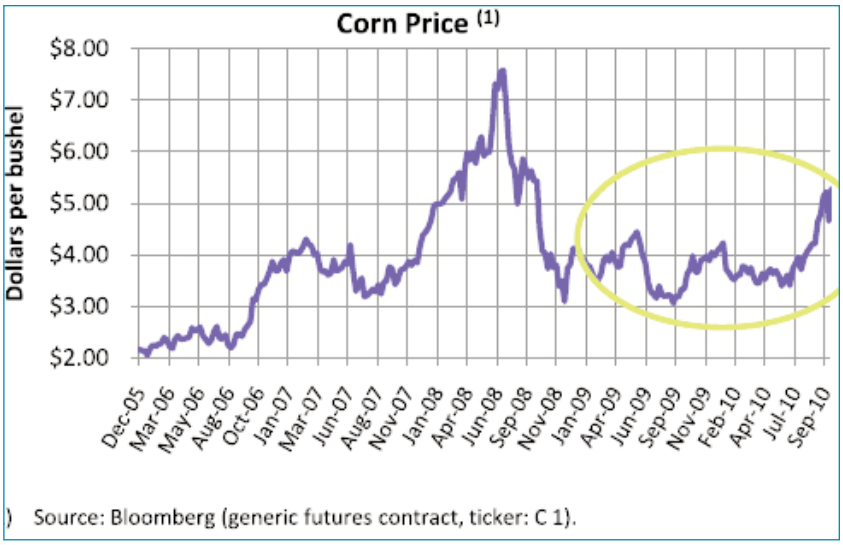
Corn. Boxcar has been in and out of sugar twice since the end of 2007, very profitably, but for now, I like corn. Even though I recognize that, after two limit-up days in a row and all of those headlines, we could be in a period when corn is overbought. It has definitely had a huge move, and the **Commitments of Traders** report shows that funds are very long; almost the longest they have been this year. So I certainly wouldn't rule out a correction. There is definitely a lot of talk floating around again about food inflation.

None of that bothers you?

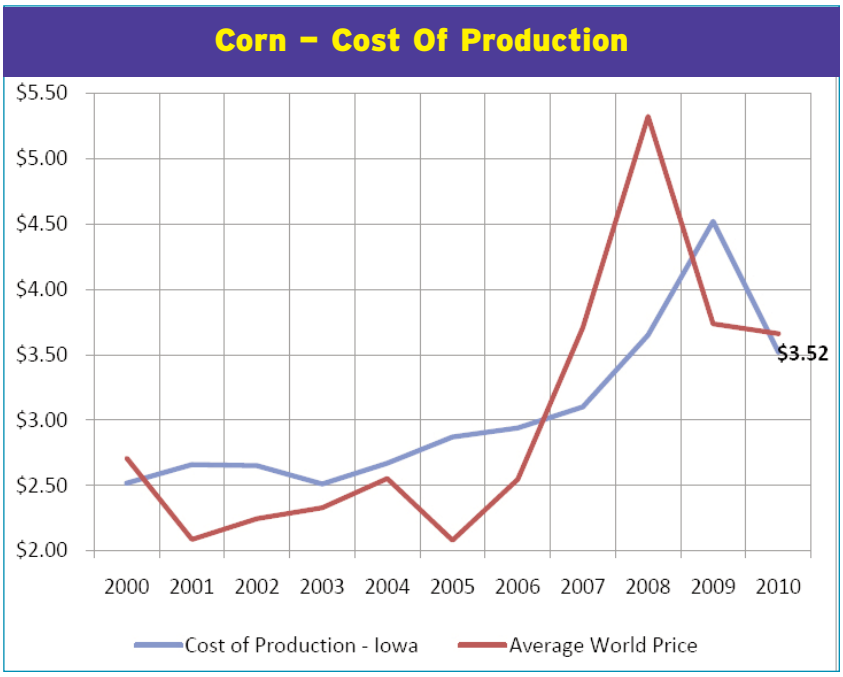
It doesn't thrill me, but taking a broader perspective about where things are headed, long term – and about where fund interest is headed long term – I really do think corn prices have a lot of room to grow. The fact that the stocks-to-use ratio is so low and that the old crop/new crop spread is so wide tends to show that there is real true demand in the market, not merely speculative demand.

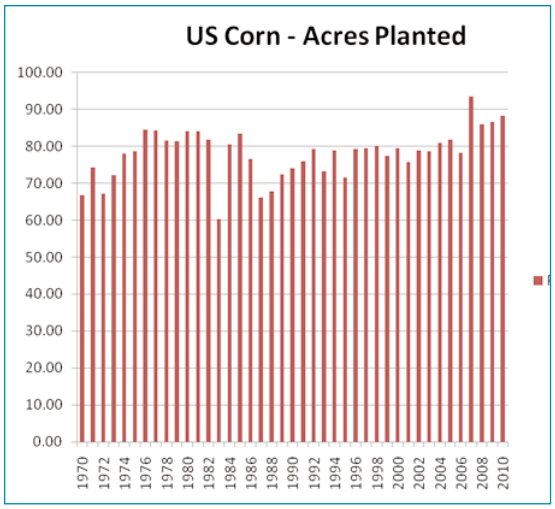
How do you figure?

Because backwardation (when the prices of nearby futures are more expensive than ones

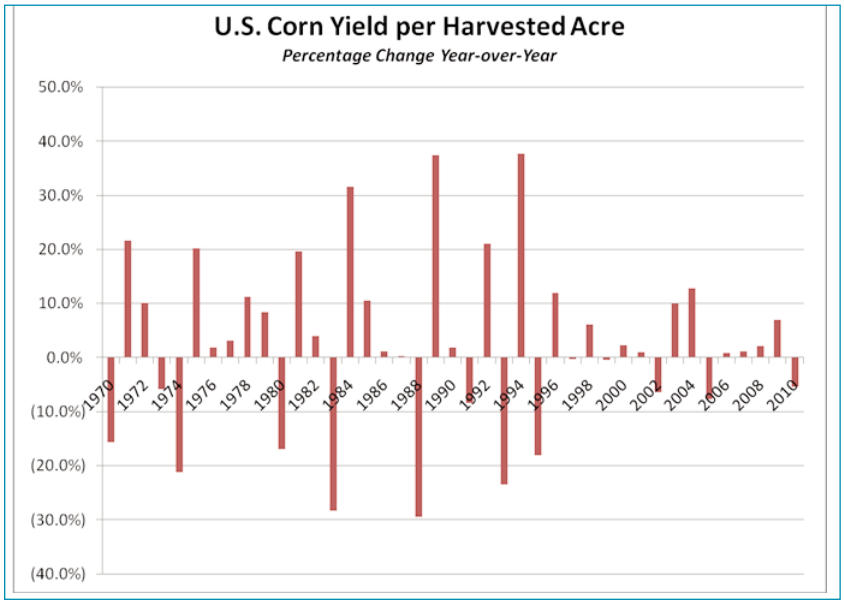


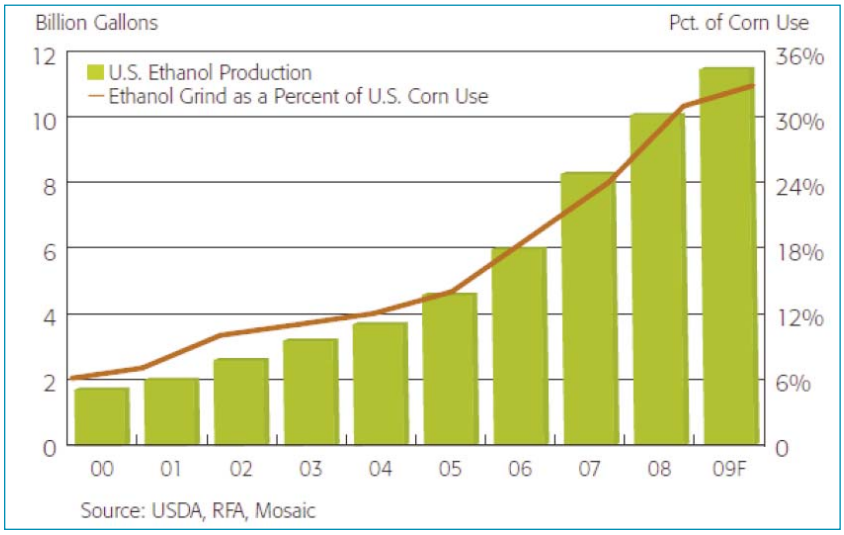
farther out) more often than not shows people are willing to pay up to get the commodity *now*. So I think that you're seeing in corn now is that kind of very real demand. I also think, going back to the chart comparing the money in commodities ETFs to the market caps of those big caps, that the investment interest today in commodities is still comparatively insignificant. If you were to look at the net open interest of the specs in corn, which is probably around 400,000 contracts right now (approximately $11.3 billion), in the scheme of things, that doesn't amount to much money. We're not even talking about 5% of the market cap of Apple. In fact, we have been trying to put a dollar figure on the total value of all traded commodities futures, globally. We think the number is somewhere around a trillion dollars, but we have had





a lot of trouble verifying this; surprisingly, neither the CFTC nor the Bank for International Settlements seems to have done the calculations. But if you think about that number and consider that we're talking about the trading valuation of all the real assets we need for sustaining life and economies, that's really not much. So I think Ag commodities prices, especially, can go a lot higher in the long term. One other thing history teaches is that commodities tend to have much larger moves than one could ever imagine, before they spike.





For example?

When copper was at 50 cents, if you had come out and said copper is going to be $4, they would have thought you were nuts. And now copper moves in a day almost as much as it used to in a week. In like vein, I can definitely see $10 corn and potentially see $15 corn, versus today's $5. But these are more long-term projections. In the near-term, it does seem like a little bit of the extra speculative interest, or fast money, might fall out of the market, which could lead to short-term correction.

That's a lot of corn price inflation. And at some point, as you said earlier, people get very sensitive to food price increases. Substitution happens.

You're right. I'm not saying that we won't see some very serious volatility in these markets. To the extent that corn can be limit up for two days; it can be limit down for two days. But the longer-term trend is higher. This volatility in the Ag markets isn't as much an artifact of funds flows as it is a supply/demand story. Getting out of the office and doing field research is another very important part of commodities analysis at Boxcar and I was pretty amazed, when I visited some farms in Indiana about two months ago, at how much difficulty the farmers were having. Not only are their equipment and supplies expensive, but the crops just aren't easy to grow. With corn prices at these levels, they're working on very slim margins, when compared to those on industrial commodities. They're nothing like **Freeport McMoRan** (FCX), which is doing darn well with copper at these prices, makes. That trip was incredibly helpful, actually. Some very interesting things came up that I was surprised the Street didn't pick up on until weeks later.

Like what?

Like that the USDA's yield estimates were way too rosy. The farmers didn't hesitate to tell me when I went out there that they didn't know what the heck the USDA was thinking; that the crop wouldn't be close to what they were estimating. It wasn't that the weather had been horrible, it was just a little bit hotter or a little bit drier than normal. But when expectations in any market are priced to perfection, disappointment is going to cost you. Anyway, going into the field to talk to farmers or miners or distrib-

utors can be very helpful. If you are looking at screens all day you can lose perspective about what you're really dealing with. So while we definitely use technicals and look at spreads and market history and fundamental statistics, I do really think that the most valuable fundamental research comes from doing stuff on the ground like I did in Indiana last summer.

Well, have you gleaned anything from market history that's informing your bullish stand on corn here?
One of the things I have been reading up on recently is what they called "The Great Grain Robbery" in the '70s.

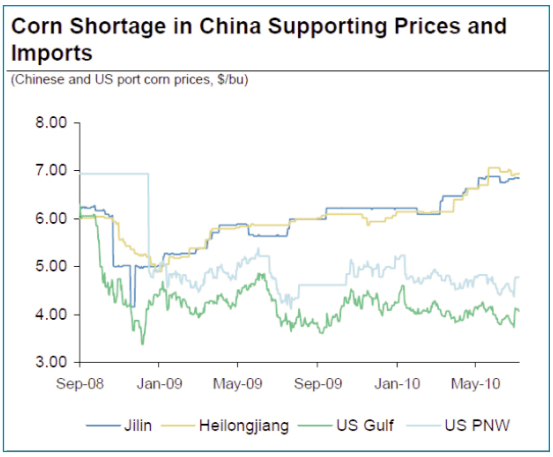
That rings a bell – but only a dim one.
That was when the Russians bought a lot of grain, very secretly, from Cargill and other grain merchants and then all of a sudden –

The market discovered supplies were short and prices shot up.
Yes, there were major shortages. That's something that you could see happen with China. They are trying to be so quiet about it, but I get a sense, just reading everything I can, that they're kind of playing poker here. There appear to be some issues with their crop. They have been a very marginal exporter of corn for a couple of years, but they basically consume as much as they can produce. It does look like they're very much at the tipping point of becoming a net importer. Currently, China imports only about 2% of U.S. corn, so obviously any huge increase in demand from China could strain supply and push prices much higher.

Excuse me, but potential Chinese demand always seems like it's the first and last resort of every bull in every market.
Fair enough. You can argue that Chinese demand has not yet played any real role in the U.S. corn market. But there are some signs, I think, that where we are with China in the grains is where we were with them in the metals in 2002. There are some strong signs that Chinese stocks are not what they say they are.

What sort of signs?
One thing that is interesting is that corn traded on the **Dalian Exchange** in China has been trading at a very large premium to U.S. prices in the last year. It's been trading closer to $7.80 a bushel.

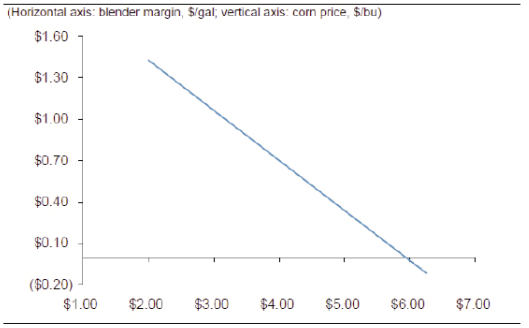
Granted, Chinese "markets" aren't often worthy of that name, but why hasn't such a large premium been arbitraged away?
I have been looking into that. The price has really spiked up in the past year. I think it is difficult to arbitrage because of things like shipping costs and the VAT – but that certainly doesn't stop it in other markets. The other factor that's important to look at is that the Chinese claim their stocks are very high, with stocks-to-use ratios above 30%, which is several times the U.S. ratio and more than double the world ratio. If this is the case, why is corn in China trading at a premium at all? Meanwhile, the Chinese are very much posturing about how they're going to buy grain from us. The amount of grain they're buying in the market currently is so minimal that it appears they are doing it to test ways to get into the market. The way that they talk about their grain stocks being so high is very reminiscent of copper and iron ore several years ago, when they claimed to have plenty as they tried to negotiate prices down. At the very least, I will observe that when you look at the metals market today, there's an enormous China factor priced in. But when you look at the grains market, it has not been a dominant issue – though I expect it to be, long term.



Disappointing yields and China aren't your whole bull case on corn, are they?
Absolutely not. Grain export bans in Russia and the Ukraine, starting last August, are exacerbating a tight supply situation; at 15.8% for 2010-2011, the global stocks-to-use ratio for corn is at one of its lowest points since the 1970s. And there are other real strains on the demand side of the corn market that are very long-term issues. The biggest is ethanol, which now consumes over one-third of annual corn production in the U.S. [see chart, opposite] – and ethanol use is expected to continue to grow substantially.

Over a third of the food crop is going into gas tanks? I'm sorry, that's nuts.
Especially when you consider that the U.S. produces around 40% of the world's corn. And when

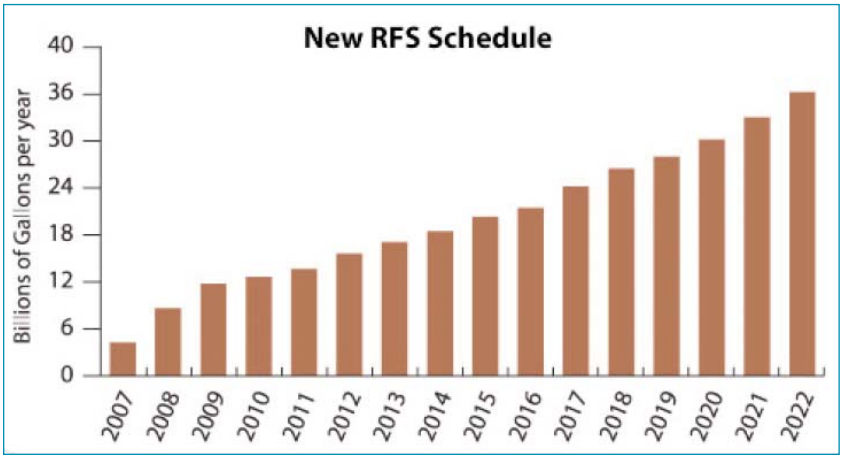
Exhibit 6
Discretionary Blending Profitable Up to $6.00/bu Corn



Source: Bloomberg, NYMEX, CME/CBOT, Morgan Stanley Commodity Research estimates

you realize that commodities prices tend to be made on the margin and all of sudden you have this fairly new entrant consuming 34% of the market. You really are going to have to have darn good yields to meet that demand. One reason for the growth in ethanol usage is the ethanol subsidy, which may get cut, but doesn't look like it's going away anytime soon.

Last I looked, corn ethanol was at best a wash, in energy terms – it takes as much energy to make the stuff as it generates –
Ethanol manufacturers and the corn lobby will claim that it is getting better. But most things that I have seen point to making ethanol from sugarcane being around eight times more energy efficient than making it from corn, and say that the energy-corn ratio at best is about one-to-one. Which means that it takes about the same amount of energy to make corn-based ethanol as it produces. It's really a zero-sum game. With that said, the subsidy is there, currently 45 cents per gallon. There has been a proposal floating around the House Ways and Means Committee to cut it to 36 cents, as a way to generate revenue to pay for some infrastructure projects, but eliminating it is a political non-starter; it's a very strong lobby in Washington. Even if the amount is changed, the subsidy is highly unlikely to go away anytime soon. It is a big part of the corn market; potentially it is a big demand driver. With the blending margin (gasoline less ethanol plus the subsidy) recently almost at $1 a gallon, there's plenty of incentive to make the stuff [see chart above].



Isn't the EPA also looking to increase the amount of ethanol blended into gasoline?
The Energy Independence and Security Act of 2007 amended and increased the EPA's renewable fuel standards (RFS) ethanol blend rate schedule, requiring 9 billion gallons of renewable fuel use in 2008, stepping up to 36 billion gallons by 2022 [See chart, below].

What? Making that much ethanol would use up more corn than American farmers produce in a year –
With today's manufacturing methods, yes. But the modified RFS essentially caps corn-based (conventional) ethanol at 15 billion gallons by 2015, while decreeing that the rest of those 36 billion gallons come from so-called advanced biofuels, such as cellulosic and other non-corn-based ethanols. The latest data I have seen, based on April consumption levels, puts current U.S. ethanol consumption at 12.8 billion gallons a year. Meanwhile, the EPA just decided to increase the percentage of ethanol that can be blended into a gallon of gas to 15% from 10%, at least for cars built in 2007 and later models. But reports have surfaced about E-15 damaging some older engines, so the EPA has put off a decision on expanding the marketing of E-15 to them. There are indications that the market will be slow to embrace the higher blend, at least until a much larger segment of the fleet can use it. Retailers are not required to invest in the new tanks and dispensing equipment they'd need to sell it; a thicket of state and local regulatory and market hurdles will slow its adoption. Nonetheless, the long-term trend points to higher corn demand from ethanol producers.

These record corn prices aren't high enough, you said, to discourage the ethanol manufacturers?
They will crimp margins a little but at $5 corn we're not yet at a price where it would be politically feasible to pull the ethanol subsidy or to change the renewable fuel standards. All you have to do is look at the sugar price supports, if you want to understand why I'm very skeptical of any near-term ethanol repeal, no matter how crazy the economics. The sugar subsidy makes absolutely no sense and sucks up quite a lot of money, but we can't get it repealed. And it benefits *very few* producers whereas the ethanol subsidy does benefit a lot of farmers. When you look at how agricultural subsidies have worked over time in the U.S., it's very disconcerting. Anyway, even leaving aside politics, I think we're going to

see a lot of volatility in the grain markets. What happened with wheat early last summer was a harbinger of things to come.

How so?

When Russia announced its export ban, wheat had a couple of limit-up days. Then a limit-down day and then a decent drop in price. It appears that there's a much higher floor in wheat right now than there was before the export bans. I think that higher floor is here to stay. But so is volatility, I expect. Especially considering that according to last week's COT report, the funds are the longest they have been all year in corn and soybeans. I could see a rush to the exits on speculation around the current report, to take profits, but I still think prices will trend higher. Corn actually went into pretty extreme backwardation a couple of weeks ago, and the latest crop report only enhanced that. The Dec. of 2011 [December futures contract] and Dec. of 2012 are trading at very large discounts to Dec. of 2010. Clearly, the main story there is the yield surprise in the USDA report, but I think the long-term issues around ethanol demand and yields being generally priced for perfection will continue in 2011. What's more, the China story could be a much bigger issue in 2011, if they really are at a tipping point of becoming an importer.

I'm getting the picture that you're bullish on corn even at these levels –

Yes. As I said, corn is still trading at only a fraction of its inflation-adjusted all-time high. We started buying corn in Back 40 in January, 2009, when corn was $3.87 a bushel – and when speculative net interest, as reported in the CFTC's COT report, was at the lowest level since 2006. But in the grains, where it is very difficult to have passive investments – something, unfortunately, most buyers of commodities-based ETFs apparently don't understand – I do use options on futures quite a bit. While corn is currently backwardation, that hasn't always been the case over this stretch, and it can be quite expensive to buy a contract and to roll it or to buy the contract a year out.

When the market is in contango that's a recipe for throwing away money.

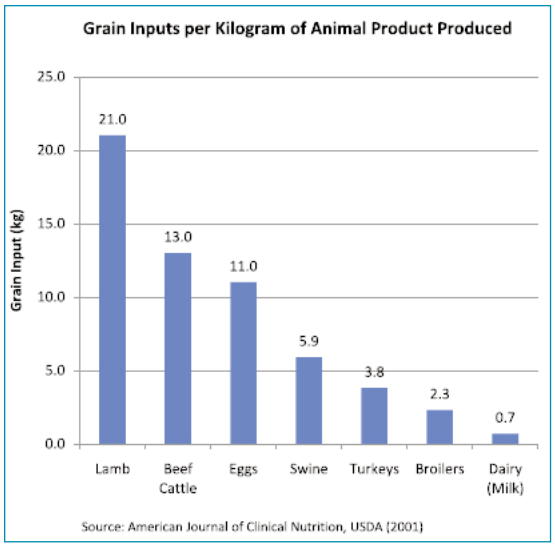
Exactly. You basically have a negative roll. It is as if you are starting out your year down. In a lot of the commodities, the contango has been so steep that it has been like starting out the year down anywhere from 8% to 14%. So you really have to *believe* that commodities are going up *a lot* every year to hold a passive investment under those circumstances. That's why I use options strategies along with my fundamental, technical and historical research to invest in these markets. That's what has allowed me to stay with this corn trade for such a long time. I have been able to buy corn and stick with it a little longer because I was selling calls against the position until I felt like everything fundamentally and technically was lined up correctly for me to take a bigger position – and one not entirely capped with options. So now, when I feel that things are getting a little bit frothy, I tend to try to sell some options against part of my position to get a little bit of income. My hope is that, if there is a correction, I have the opportunity to buy more in front of what I think is going to be a long-term trend. I also have moved a lot of my Dec. of 2010 corn into Dec. of 2011 to take advantage of the backwardation – and expecting that the fundamentals will be even more bullish next year. The Dec. of 2011 are really the best of both worlds: A positive roll and even more bullish fundamentals.

What about wheat?

I'm much more excited about the other agricultural commodities. I do think wheat is going to go higher, but I'm not all that excited about it, because it's likely that the price will be driven more by the corn markets than by the wheat market. That said we have seen that droughts can obviously lead to problems with wheat. In fact, water is such a big issue for wheat, and the other grains, that I make the case that grain futures can be used as a vehicle for investing in the world's increasingly scarce water resources.

In what way?

Basically, to the extent that we see countries doing what Saudi Arabia did in 2009, when it abandoned a 30-year program to grow wheat (in which it had achieved self-sufficiency but depleted scarce water supplies) and returned to importing wheat, it is very bullish for wheat prices. It makes it evident that by importing wheat, nations are importing water. The Saudis calculated that they could save1,300 to 1,500 cubic meters of water for every ton of wheat they imported instead of producing. A lot of other countries are looking at that. China understands it. Grain futures may be the best instrument for investing in water. After all, it's difficult to find pure-play investments in water; they tend to be either too specialized (utilities, water treatment companies, water rights companies, infrastructure projects), or too broad, like Coke and Nestle, where water is only a small part of a huge conglomerate. And water shortages are likely to have dramatic upward impact on grain prices.

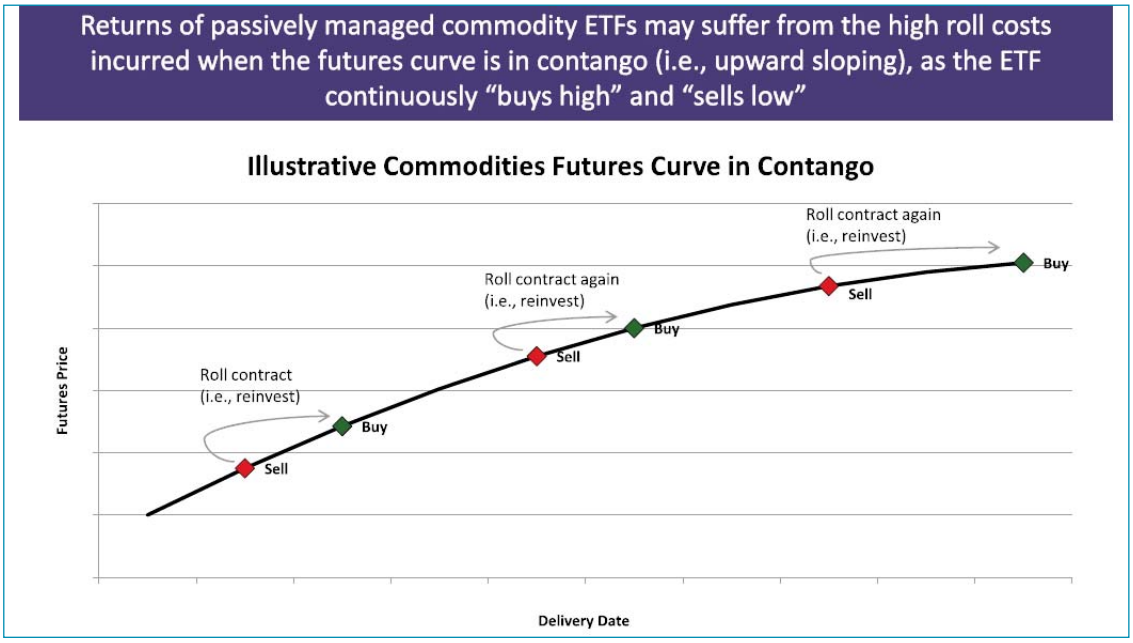


That sure sounds like a bull case.

Well, droughts in Australia from 2003-2008 led to dramatic rice and wheat shortages worldwide. The drought's severity in '08 led to significant spikes in global grain prices and sparked the food panic I mentioned earlier that even affected Costco – before it was cut short by the credit crisis. But the move in wheat in 2008 was so extreme and so parabolic that it really hurt the market in ways that are still playing out. You did get substitution in feed grain and you did get a lot of countries expanding their wheat growing acreage and things like that, which are still making wheat a little less exciting than corn here. Not that I think it won't trade significantly higher. One thing that has been very interesting about wheat this year is that, until this summer, the specs were actually net short wheat – they had maintained that short position for almost a year after the big spike up. So I get the sense that wheat is not a commodity that has made money for a lot of speculators this year, despite the move up. Even now, they are only something like 22,000 contracts net long; nothing like in corn. Anyway, while wheat is going to be more or less just following in corn's footsteps, there is no reason that we can't see prices at least double from here. The problem with the wheat market here from an investor perspective is that it is in a pretty deep contango. December '11 wheat is around 7.50 and December '10 is around 7.12, which is a pretty significant hurdle to get over. Longer term, of course, from an emerging markets perspective, there's definitely a case to be made for all of the grains, as increasing prosperity allows more and more people to move up the food chain. It's a simple fact that the amount of grain needed to sustain a diet based on the consumption of beef and chicken is much higher than what's used when people subsist on rice for the most part [See chart nearby]. It's not that commodities are immune to corrections, substitution does happen, as we saw in 2008 when prices spike too high. But I do think that floor prices are being pretty continually set higher.

Another harbinger of inflation to come?

I think so. 2008 was kind of amazing when you think back. Just a small slice, I suspect, of things to come. And the problem with food inflation is that it does feed on itself. It does lead to hoarding and it does lead to countries doing things that cause more problems, even when there is plenty of food around. In those cases, there then can be sharp corrections. Though I will admit that the sharp correction in '08 was caused more by the credit crisis than the fundamentals, and it was exacerbated in the grains by the ethanol manufacturers. They had decided during the run-up that they could make more money hoarding corn and selling futures than by making ethanol, and when the crisis hit, they ended up having to dump corn stocks on the market, worsening the decline. But generally, once the notion of food inflation takes hold in people's minds, they start rioting in places and then countries shut off exports and it really can feed on itself.



Turning back to commodities investments, you clearly believe in active management – even if that is "talking your book" since that's what Boxcar offers.

Absolutely, no doubt. Commodities ETFs in general are simply a poor replacement for active management, with very few exceptions. The gold ETF, the GLD, is fairly solid, because it actually owns the physical gold. But many of the ETFs,

especially in the agricultural and energy sectors, have a lot of issues. One, they tend to have tremendous tracking error against their benchmarks, for example, in the case of the **U.S. Oil Fund** (USO), its prospectus states that they target a tracking error of plus/minus 10. Two, they have this issue of dealing with contango – and most of the commodities markets currently are in contango – which leads to a large negative roll yield as futures are rolled passively, without regard to roll costs, which can dramatically reduce returns from price appreciation as the ETF continuously "buys high" and "sells low." [See chart below, opposite]. So a person who invested, for example, in the crude ETF at the price lows of '08 is probably only up about 10%.

Ouch, $30 to $80 and they have only captured 10% – what a deal. And it's only recently that those ETFs have been "outed" in the press.

Right. It's a fairly confusing issue. But if you add contango and tracking error together, it can be very dangerous. For the most part, the ETFs, with the exception of GLD are not serving the purposes most investors think they are – which I think will continue to be very problematic. And I have read recently that one of the large aluminum companies is talking about launching an aluminum ETF– as a way of unloading its inventories on investors!

That speaks volumes.

Yes. Talk about storage costs. The idea that there are companies saying, "We have got too much aluminum, why don't we go start an ETF and then it will just be warehoused to investor demand," is mind-boggling. I almost fell off of my chair. Couldn't believe what I was reading. Then the other issue with ETFs is that they are stuck, by design, with having to roll at certain times – which are publicly disclosed. So a lot of people know when they're rolling and try to push against them in the market.

Right, they might as well have big targets painted on their backs.

Some have tried to get a little cagier, but they're still stuck with very passive management, rolling without real regard to fundamentals or to backwardation or to what's going on in these markets. Even though, at the moment, commodities may still seem pretty correlated as an asset class, history certainly says that's not usually the case, and there are signs here and there that they are returning to more normal trading patterns based on supply/demand.

There are?

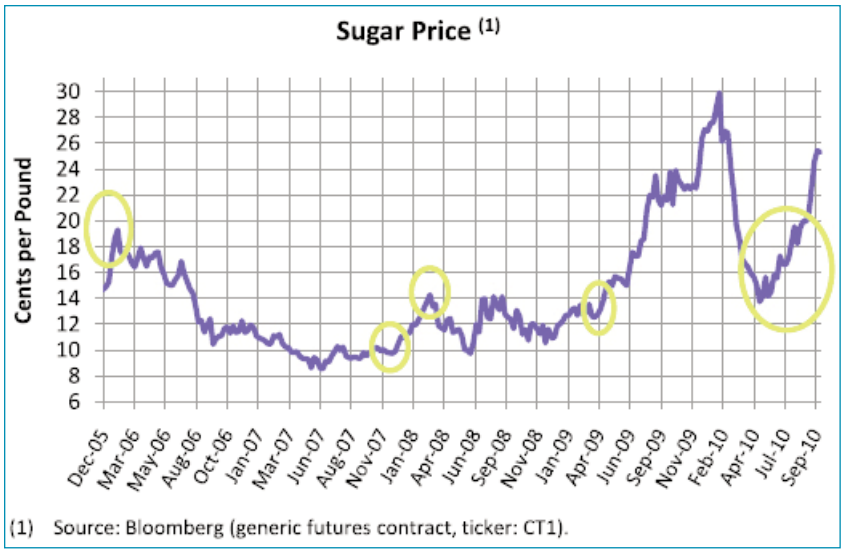
It seems like it to me, with the exception of the metals. I mean, you can argue that crude has been reacting to an oversupply and that the grains have finally been reacting to expectations being out of whack, the crops not being great, low stocks and increased demand. The reality is that different commodities do have their own unique characteristics– and that makes them different than other asset classes. So it is going to be important to start differentiating between them as the market stops being all about risk on/risk off trades and more about supply and demand. I still believe it's good to have portfolio exposure to a diverse group of commodities with the correct supply and demand dynamics and limited negative roll yield. But you really require *active* management for that.

Isn't it still true though, that floods of passive money, not just from ETFs but from various institutional investment vehicles, can overwhelm the fundamentals from time to time? Commodities markets just aren't that big, as you pointed out.

Yes. That's a very tough thing. It is something I think I will be able to take advantage of, on the one hand, but I know a lot of experienced commodities investors who are very frustrated with all the passive money that has come into the markets, because it so often defies logic. The passive money, by definition, isn't doing any fundamental analysis and that can really skew things. In general, investment demand has become a fundamental of its own in many of the commodities markets. Definitely in the precious metals markets. I do think that investment demand is, for the most part, here to stay. Although, as we saw in 2008, how that plays out when there's a liquidity crisis is an issue. But it creates opportunities, when the passive money comes flying out, for those who can differentiate what is overpriced from what is a good value.

No doubt that can be a bonanza for savvy speculators. But it also has real world consequences for producers and consumers of commodities – meaning all of us.

Exactly. Though it can work in both directions. One example of fund flows having a very large impact on commodities prices was visible earlier this year in the world sugar market. The sugar market has been in deficit, meaning demand has been in excess of supply. What happened was that



the world price had fallen during 2006 and 2007, dropping below 10 cents a pound – which was well below India's cost of production. The upshot was that India, the world's second-largest sugar exporter, cut production dramatically in 2008-2009 and became a net importer, which caused huge strains on the markets. So the funds got extremely long last year – and the sugar price spiked up to 30 cents around the beginning of this year. But then it very quickly–in a matter of weeks–collapsed to 13.

What happened?

When I spoke to people in the sugar business, they attributed a lot of the selloff to the funds immediately fleeing for the exits when price of sugar failed to break through the 30-cent level. That was also right about the time that lots of investors were very worried about Europe. It was clear to me, though, that a flight to the exits that pushed the price down by 50% in a matter of weeks – and to below the cost of production in a commodity in a deficit – probably wasn't warranted. I spoke to farmers and a lot of the sugar companies and they all confirmed that those price lows were below the cost of production, even for the lowest-cost producers. That provided me with an opportunity to buy sugar at a great price in April (15.19 cents a pound) – after a large correction and when nothing had really fundamentally changed in the market. There was still a deficit and there was still a lot of demand worldwide.

Do you still like sugar?

Well, at these prices, it's a little bit less interesting. It's pretty much done a roundtrip [see chart, nearby]. March sugar is around 26 cents. It has been a very wild ride. Interestingly, though, this is another of the few markets that is still in backwardation. So this is a case where I had bought front-month sugar back in April, but when it hit my price target, which was around 19.5 cents, I moved out into the later years.

I'm guessing you have employed options strategies in sugar, too.

I did. At the time sugar was 15, I actually was able to sell some puts just to give myself a little bit of buffer in case the price went down a little further in the volatile market. I knew there really was a floor; there simply wouldn't be more produced, if it got below a certain price, but as I said, the volatility was wild. The option strategy capped out my upside around the 19 area on the portion of my position that I sold calls against. Because the volatility was so incredibly high, I was able to sell both a put and a call and cover sugar going anywhere from around 13 cents to around 18. So the options strategy really gave me a lot of room to breathe on the position. Whenever I am selling or buying options, what I look for is an appropriate risk/reward. I look at any option strategy as a directional strategy, in the sense that if I'm selling a put, I view it as owning the future. From a risk management standpoint, I look at the notional underlying exposure. I really like to make sure, in options, that I have a very good buffer on either side. There are also times – when I think options are inexpensive and I think there could be a dramatic move – that I will actually buy options positions, instead of just using them as hedging tools. That is something I did last May, buying puts on crude when volatility was low and the options were relatively inexpensive.

Nice timing. Why did you turn bearish?

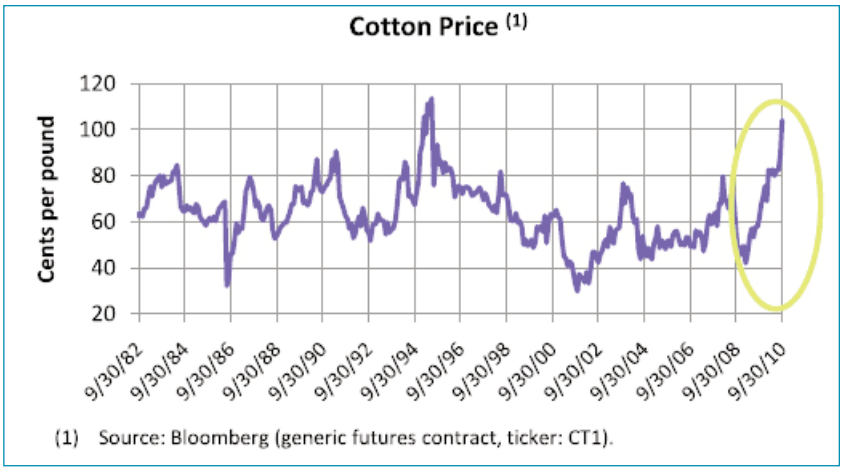
Just because I was very nervous about the high inventory levels and concerned about the global economy. Plus, there was a very large speculative interest in crude at that juncture. So I figured that crude would be a likely target, if the funds decided to run for the exits. But generally speaking, I use the options for positioning. When I look at buying a commodity, I look at it from every angle along the options to futures spectrum, before deciding how to proceed. While employing options has costs and adds a layer of complexity, I don't feel it has capped my gains in markets where we have had very large moves, and it is a way to manage risks, to deal with some of the issues surrounding contango in commodities markets – and to avoid the capital drain that is often associated with passive commodities strate-

gies.

Let's talk about that other commodity making headlines with rising prices: Cotton.
It has been extremely volatile and is one of the areas where speculation certainly has become an issue [see chart, at right]. Along with wheat, it was one of the real problem areas in '08. When the cotton market collapsed from $1 to somewhere in the 35 cents a pound range in less than a year, it put a lot of cotton companies that had been around for generations out of business. Two of the biggest old-line middlemen cotton companies merged and one went bankrupt. More recently, the number of limit-move days – in both directions – has been fairly excessive for the last couple of weeks–and this week has definitely been wild.

Should I take it, then, that you're not invested in cotton?
Not anymore. Back 40 bought cotton back in November of '08, after it had declined to 43 cents a pound. I had met with U.S. farmers and realized that, amid the financial crisis and upheaval in the industry, the cotton crop was likely to shrink. Cotton is difficult to grow, requiring long lead times and lots of water and labor, so farmers had lots of incentives, on top of the low price, to rotate to other crops. We started selling some of our position in May of 2009, when cotton hit 59 cents a pound. Then, last April, when the current crop month started trading at a large premium to the new crop months, producing a very backwardated market, we started selling some of Back 40's position in front-month cotton at 82 cents and buying new crop cotton at 77 cents. But we exited the remainder of the position this week, at around $1.

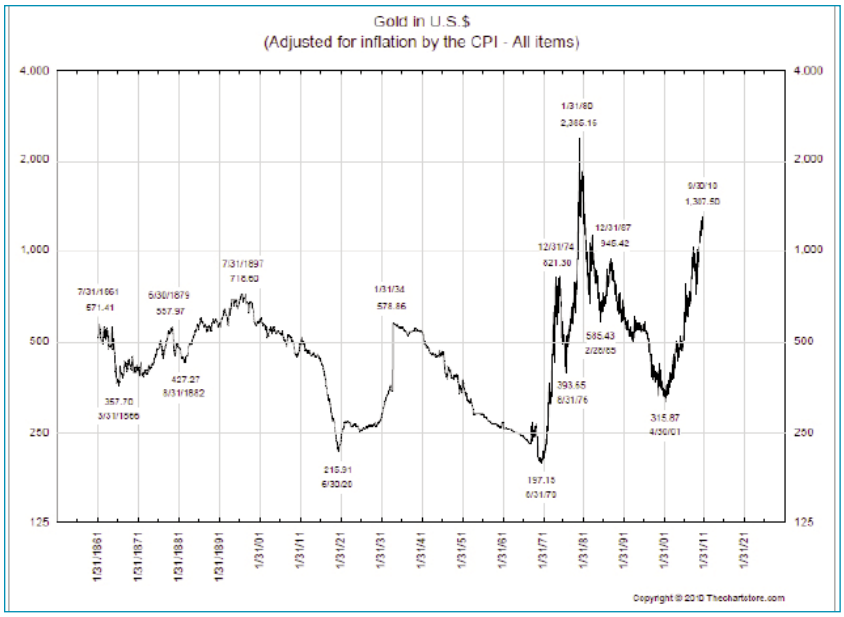
The *WSJ* headline about cotton breaking a Civil War record was too much for you?
It wasn't that, though that was quite an article. It appears that there is better value in grains such as corn, and the price action – with continually expanding limits both up and down – was reminiscent of March of 2008, not a sign of a healthy market or a good risk/reward at these levels. When I do decide to reestablish the position, I will look at cotton further down the curve, as the backwardation is very extreme. For example, despite the record print in front-month cotton so prominently displayed on the cover of the *Journal*, the Dec. of 2011 is trading at 86 cents! Besides, from what we can see, there is still a lot of passive investment money in cotton – and all



across the commodities space, really. It doesn't seem that there were many lessons learned in 2008. The CFTC has made some efforts to shed a little bit more light on the funds and the swaps dealers. They are providing disaggregated data on the positions in the agriculture markets to show what really is activity by managed money and what activity is the swaps dealers – who, it was suspected in '08, actually controlled the majority of the commodities markets. So there is, at least, some movement towards transparency. But as a commodities investor, I do think the heavy involvement of the passive institutional funds can be an issue at times. One thing that the CFTC could do would be to raise margin requirements. There doesn't seem to be any real reason why an investor – even one like me – should only have to put up between 2% and 5% to control a contract.

That's a whole lot of leverage. And commodities are about the only place you can find that today.
Very true. That's why, from a risk management perspective, what's important to me isn't how much margin I put down, it's my notional downside exposure. Looking at it that way helps me minimize the risk of the leverage, because I really understand what I own. You can still be an investor and use leverage without having to take it to 20 times or higher.

Too bad guys weren't thinking that way in the CDS and CDO markets in the run-up to the financial crisis.
Yes, that was an issue. There is a lot of room for abuse in these markets. But that said, the commodities markets are very exciting here. Given our unprecedented monetary and fiscal policies, as I said, there is enormous potential for inflation of just unprecedented magnitude. Any way you look at it, hard assets and especially commodi-



ties that have utility are likely to be the beneficiaries of all of the money that has been pumped into the system. They can keep printing more money and issuing more debt, but you can't create more of these various commodities, at least not until their prices go much higher.

On the other hand, commodities don't throw off a stream of earnings or dividend income. A commodity is only worth what you can get the next guy to buy it for.
True. Though those are some of the reasons I use options strategies – to garner income on commodities positions.

You said when we started that you like Ag better, but you still sound attracted to the metals.
Yes, though on the base metals, I'm a little bit more cautious just because it is a very much China story. And it is very difficult to get the correct numbers out of China.

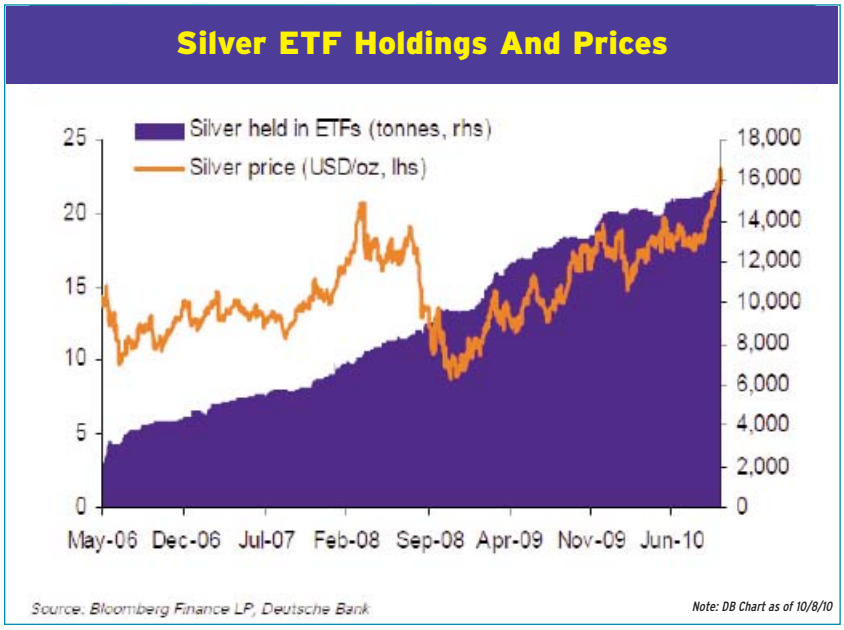
No, really?
As you observed, I'm prone to understatement.

Did you see the piece in today's *Financial Times*, about China making a killing on a well-timed purchase of copper?
Yes, some $1.5 billion, because they bought copper around $1.90 when it crashed. China is the best hedge fund there is. They clearly recognize the one very important fundamental that's often overlooked in the commodities markets: price.

***Price* is a fundamental?**
Price truly is a fundamental because you can look at the supply/demand equation all you want, but at a certain higher price, new supply does show up out of nowhere. It's sort of amazing how that happens, but it does. And likewise, at a certain higher price, demand will be hurt by substitution. And the same dynamic works on the flip side. A certain low price will shut down marginal supply. For instance, one area where I have a long-term bullish view is natural gas, because I think these low prices could really generate demand. There's definitely a large supply overhang, between the shale finds in the U.S. and LNG imports. But we have now had nat gas in the $3 to $4.50 range for a couple of years, which I see generating long-term demand. Conversions from coal and vehicle usage, those sorts of things.

So am I right that you also like gold better than things like platinum?
Yes, basically because those metals have had such big runs and gold can maintain higher prices even when it loses luster in the jewelry market, because it can function more as a currency than a commodity. Despite all of the talk you have heard about gold, it under-performed a lot of the other commodities last year: lead and copper, and also platinum and palladium. Granted, there have just been platinum and palladium ETFs created, which could have very unforeseen long-term consequences, but for now that's pushing their prices much higher.

Unforeseen consequences?



I was actually very surprised when the platinum and palladium ETFs were allowed to launch because those markets tend to be very, very limited in terms of supply. Much more limited than silver, and a lot of companies involved in silver purchasing lobbied fairly hard for the CFTC *not* to approve the silver ETF. They voiced concerns that it would make it more difficult for companies actually using silver to obtain supplies. That's one risk we're running with many of these ETFs – the possibility of passive investor demand overwhelming the physical market. There could be issues with delivery against them if it gets to the point where there are more ETF shares than there is the commodity to go around. It could lead to some real squeezes. Anyway, what I was going to say is that even though gold looks attractive compared to the platinum group metals, the metal that holds the most long-term attraction for me here actually is silver.

Why silver?

Like gold, it is a store of value, but it also has lots of utility. It's the best conductor of electricity and heat of all metals, in addition to being very strong, corrosion resistant and even having anti-bacterial properties. Another thing in silver's favor as a commodity investment is that most of the substitution that could take place in industry to reduce demand for it has already happened. (Think about photography going digital.) Interestingly, there was very little drop in demand in the ETF during the 2008 crisis. The ratio of gold to silver is currently around 57. Historically, the ratio has traded much lower. The price of gold one day last week moved by a $25 nominal amount – greater than the total nominal price of an ounce of silver. Long-term, the ratio should move to half of where it is today. What's more, there's even a China story attached to silver.

Of course. Do tell.

In 2008, China moved from being a net exporter of silver to a net importer, most likely as a result of a combination of rising industrial consumption and the emergence of retail investment demand. [See chart, above]. In fact, Deutsche Bank has forecast that China's silver imports will set records this year. So I really think that silver could be a very, very exciting metal long-term. It is a fairly illiquid market – some things about it haven't changed much since the **Hunt Brothers**' days – so investment demand in silver could overwhelm the market. That said, over the near-term, I think both silver and gold are vulnerable to corrections caused by a potential reversal in the dollar – which, as we have seen, can be quite sharp. But they should trade much higher against the major paper currencies over the next several years.

Thanks, Melanie.