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Commodity-Price Scapegoats

By Donald L. Luskin

In the political quest to place blame for high food and energy prices, a new scapegoat has been found: commodity index funds. Politicians of both parties, energy company executives and farm lobbying organizations all agree these funds should be regulated or prohibited altogether. Who says this is an age of political discord?

The Commodities Futures Trading Commission, charged with overseeing these markets, has said there is no rigorous evidence commodity index funds have any particular effect on commodity prices – and plenty of reasons to think that they don't. Nevertheless, it was reported over the weekend that the CFTC will likely bow to political pressure, and soon announce initiatives to crack down.

Commodity index funds are especially vulnerable politically. They are a big target – reportedly, there is about $260 billion invested in them currently. Among their largest investors are retirement funds for government employees and teachers, which by their very nature are subject to political pressure. For example, the organized labor lobby is already trying to get states to make their funds to stop investing in private equity deals in companies that won't employ union labor.

These and other investors in commodity index funds hold them for the same reason that they – and probably you, too – hold plain-vanilla stock index funds. In both cases, they're a simple, low-risk and low-cost way to get broad and diversified exposure to a major asset class.

Commodity index funds do what index managers like Vanguard have done for decades with stocks – invest passively in a portfolio designed to track a published benchmark index. For stocks, it's generally the S&P 500. For commodities, the most popular is the Goldman Sachs Commodities Index (GSCI).

The evidence against the index funds is circumstantial at best: Commodity prices have soared over the same recent period that commodity index funds have rapidly grown. So the index funds must have caused it.

But coincidence isn't causation. And such causation that can be shown to exist actually runs the other way: Rising commodity prices cause the dollar value of commodity index funds to rise, just as rising stock prices would make a stock index fund more valuable. This accounts for nearly half the reported growth in commodity index fund assets this year. But if commodity index funds are such a powerful influence on prices, how can one explain the fact that not all the commodities in the GSCI have risen?

Over the last year, the agricultural, energy and precious-metals sectors in the GSCI have risen. Livestock prices, however, have been flat, and industrial metals are lower on average – with the conspicuous exception of steel. Steel is up dramatically but is not even in the index.

In the absence of rigorous evidence, are there theoretical reasons to expect that commodity index funds should affect prices? Yes, if only that when new buyers enter a market they can be expected to drive prices higher, all else being equal.

That is no crime, even though some politicians would like to portray it as such now. But of all investors, index funds should have the least power to move prices. That has always been one of the great attractions of stock index funds, and the same principle applies to commodities.

Why? When Warren Buffett buys an individual stock – or when T. Boone Pickens buys an individual commodity – prices will rise because the market must incorporate the possibility that these experts "know something." But index funds buy broadly diversified portfolios (whether it be stocks or commodities) because they know nothing at all. Does anyone think that the California Public Employees Retirement System has any superior knowledge about crude oil or wheat? Of course not.

Unlike other commodities buyers, index funds never take physical delivery of commodities to store or consume them. They are investors, not hoarders. They don't divert any supplies from the markets. When their futures contracts near expiration, they sell them and replace them with longer-dated contracts. Thus, once their positions are established, they are perpetually both buyers and sellers in equal proportion.

And index funds, despite their size, pose no threat of market instability. Held by heavily regulated fiduciaries, they typically don't employ the enormous leverage available to futures speculators. So when prices are volatile, index funds will be an anchor of stability.

With increasing demand from emerging economies, the dollar near all-time lows, and the Federal Reserve holding interest rates below the rate of inflation, surely we can come up with better explanations for high commodity prices than the growth of commodity index funds. Sadly, those better explanations are more difficult to swallow politically.

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