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Factors Collide to Strain Food Supplies and Drive Up Prices

What goes around comes around, but it can take a while. One old issue that's come back around lately is a run of surging prices and apparent strains for the world's food supply.

Concern about feeding a growing world is not new. Most famously political economist Robert Malthus, in his 1798 "Essay on the Principle of Population," predicted that humanity would outstrip its ability to produce enough food for itself. It was a convincing case given the preceding centuries of relative stagnation in production methods and living standards, repeated famines, and economic crises. The social unrest that precipitated the French Revolution was exacerbated by the spiking of bread prices after failed wheat harvests in 1788 and '89.

Malthus didn't figure on the Industrial Revolution. With technology and mechanization leveraging human effort and ingenuity, resources grew *less* scarce. In just two centuries the world's per capita income rose tenfold. Yet as recently as 1972 the Club of Rome's treatise, "The Limits to Growth," projected an inevitable depletion of nonrenewable resources and a precipitous collapse of the economic system unless there were immediate limits placed on population and pollution and a halt to economic growth.

Such concerns are back, driven by a confluence of factors including several years of a strong global economy, unfavorable weather in key growing regions, higher shipping costs due to energy prices, and the diversion of crops to biofuels production. The U.S. dollar's fall has magnified the price surge for agricultural commodities which are mostly invoiced in dollars.

Not all food prices are up. Livestock, pork bellies, and orange juice, for example, fell in price over the past year. But wheat, corn, and soybeans have popped significantly. Wheat production in Eastern Europe, Canada, and North Africa was affected by unusually dry weather, while Western Europe suffered heavy rains and flooding.

Meanwhile, a lot of U.S. acreage was switched to corn from other crops due to subsidies and tax incentives tied to the goal of increasing ethanol output. The International Food Policy Research Institute pins a quarter to a third of global food price pressure on this factor. U.S. and European governments generously subsidize ethanol production, and as much as 20% of America's corn crop now goes to biofuels.

Today's price shocks are especially hard on consumers in developing countries who spend a much greater share of household income on food. A few have seen isolated "bread riots," and the governments of Egypt, Oman, Pakistan, China, and Russia are increasing food subsidies and imposing price controls.

History suggests that the longer term answers lie with markets and innovation. Weather patterns change, growers respond to shifting price signals, and the mechanization of agriculture continues. The U.S. currently uses about 269 tractors per 100 hectares of arable farmland, while China uses fewer than 100 and India just over 150. The percentage of the world's arable land used for farming has increased only modestly since 1950 even as global population doubled.

Some experts believe that even the U.S. could see big gains in crop yields over the next few decades from genetic science and other advances in technology. As Malthus conceded later in his life, "The main peculiarity, which distinguishes man from other animals, is the power which he possesses of very greatly increasing the means of his support." §

Shoulders to the Wheel:
U.S. Producers Pick Up the Slack

A few issues back we discussed American consumers' long-term debt build-up and wondered whether the bursting of the housing bubble and shocks to the credit markets might finally trigger a turning point. There are signs that may be the case.

Large chunks of mortgage debt are destined to be written off by lenders and those who hold securities backed by that paper. Financial institutions are tightening lending standards, and the market continues to struggle with gaps in liquidity. In addition to the weakness in housing, many retailers are reporting lackluster sales, and automakers, even that global juggernaut Toyota, are having a tough year.

On the other hand, for many U.S. companies that export to the world the picture is markedly brighter. The dollar's long slide has boosted their price-competitiveness, and productivity in America remains significantly higher than in emerging countries. In the first quarter of 2008 total U.S. exports of goods and services ran 18% ahead of the same period in 2007, 45% better than in 2005, and 81% ahead of 2003's pace. Producers of high-end goods, heavy construction equipment, and

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Many Portfolios Came Through the "Lost Decade" In Pretty Good Shape

"Stocks Tarnished by Lost Decade," declared the headline in the March 26th *Wall Street Journal*. The article itself noted specifically that the Standard & Poor's 500 Index (not counting dividends) stands right about where it was nine years ago. Of course it's no secret that the market has had a tough time making headway *this* year. But it's usually a little more reassuring to revisit those longer term numbers, most typically the 10-year numbers.

That look-back is not so reassuring these days. The market's 10-year record is dropping off some pretty hot months from a decade ago and picking up quarters that have been lackluster at best. As this *Quarterly* goes to press the average S&P 500 Index fund's *10-year* annualized total return (dividends reinvested) is 3.2%, just a hair better than the average Money Market fund at 3.1% according to Lipper. That match-up could stay close for a while as we peel away the market's big run-up through 1999 and into 2000.

Yet for many portfolios that deployed broader diversification and reasonably proficient management the picture is a little brighter. As the accompanying table shows, a level blend of the industry's average Large-cap, Mid-cap, Small-cap, Foreign, and Emerging Markets stock funds clocked an 8.3% annualized return for the trailing 10 years, a full five percentage points better than the S&P 500.

That comparison gains relevance in view of the late-'90s push for "indexed" investing – specifically S&P 500-indexed investing. A decade ago the *Client Quarterly* ran a cautionary or two on the subject, noting in the fall of 1998 that "the popularity of indexing has funneled dollars to these stocks in a kind of self-reinforcing cycle [that] could shift and exaggerate a move to the downside." The large-cap names dominating the S&P at the time turned out to be a poor choice of focus for the ensuing decade. The take-away messages may sound familiar:

1) Throwing too much weight behind the popular wisdom and hottest stories of the day can be risky.

2) Outperforming the prevailing "riskless" rate of return (money funds) by several percentage points is a very respectable *long-term* result for a prudent investor's portfolio. §

Another Entry Point for REIT Shares?

These pages first explored the portfolio diversification potential of REITs (real estate investment trusts) in the waning days of 1996. REITs were not a particularly popular investment asset at the time. The early 1990s had seen the bursting of a commercial real estate bubble that had been inflated by aggressive tax incentives, creative financing, a robust economic recovery, and the self-feeding phenomenon of rapid market appreciation. You may recognize the echo of those factors in the housing bubble now deflating.

For the ensuing decade, 1997–2006, REIT shares generally treated investors quite well, especially once the broad stock market entered its swoon early in this decade. From the start of 2001 through 2006 mutual funds specializing in real estate averaged annualized total return of 12% versus just 2% for the Standard & Poor's 500 Index, according to Morningstar. Last year that cycle turned, with the funds down nearly 15% on average. They continued to struggle through the first few months of this year but have had a nice bounce in the second quarter.

So is this another one of those opportunities to boost one's exposure to REITs? That's hard to say given the sector's sensitivity to interest rates and the economy. The upheaval in credit markets is hardly news at this point. The Fed and other market participants have been pushing the actions that traditionally point toward a recovery. Last year's sell-off has made for some attractive REIT yields, and many continue to project healthy earnings growth. The news has been markedly devoid of stories about REITs running into

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Performance Summary: Major Mutual Fund Categories*

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested ---- Annualized through June 6, 2008 ---- 1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	– 7.9%	5.9%	7.9%	3.2%
Mid-Cap Stocks (Core)	– 6.2	9.0	12.4	9.2
Small-Cap Stocks (Core) †	– 11.6	6.6	11.6	7.5
Foreign Stocks †	– 3.0	15.5	17.1	6.9
Emerging Market Stocks †	13.2	29.3	30.8	14.6
Flexible Portfolio	1.2	8.6	9.7	6.4
General Bond	3.5	3.7	4.1	5.7
Int'l Income (non-U. S.) †	12.6	4.9	5.4	5.8
High-Yield Taxable Bond †	– 2.3	4.9	6.8	3.8
General Municipal Debt	1.7	2.4	2.8	4.0

* Source: Lipper, as reported in the *Wall Street Journal*, June 7, 2008.
Past performance is NOT indicative of future results.

† Small-cap stocks and high-yield (lower rated) bonds pose greater risk and price volatility than securities of larger, well-established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

Sovereign Wealth Funds Raising Their Stakes

Sovereign wealth funds (SWFs) are investment vehicles owned by foreign governments. They've been around for some time, but they've garnered greater attention recently due to their role in recapitalizing several major financial institutions whose balance sheets were bruised by the subprime mortgage mess.

Abu Dhabi has taken a 5% stake in Citigroup for $7.5 billion; Singapore and an unnamed Middle Eastern investor sank $11.5 billion into UBS; and China has dropped billions on Barclay's Bank as well as private equity firms Blackstone and J. C. Flowers. Two Middle Eastern-based funds own, between them, about a third of the London Stock Exchange.

Time will tell if these prove to be savvy investments, but they're just the high-profile tip of the iceberg. The U.S. Treasury estimates that SWFs now control $2.5–3.0 trillion in assets. In the context of $50 trillion in global dollar-denominated assets and $165 trillion in global securities markets, it's not so much the amount controlled by SWFs but rather the concentration. The top six funds – Abu Dhabi, Singapore, Norway, Saudi Arabia, Kuwait, and China – represent nearly 90% of the total. And that doesn't count the People's Bank of China's $1.4 trillion in foreign exchange reserves.

Concerns have been raised over the potential for such concentrated pools of capital to distort markets if they were to lurch from one asset class to another, or if the controlling governments tried to exert undue influence on the companies and institutions in which they invest. SWFs have a reputation as stable, buy-and-hold investors taking mostly minority stakes. But some of the governments noted above are pretty opaque. A couple years ago the flap over Dubai's proposed purchase of the management of six major U.S. ports showed how ticklish this aspect of globalization can be.

There have been calls to establish a code of conduct for SWFs and reason to believe the funds may see value in signing on. Agreeing to a few guidelines might assuage concerns and avoid capital controls and other measures that would restrict SWFs' investment opportunities. Economist Milton Ezrati of Lord Abbett & Co. notes that "ownership, after all, is not sovereignty." Global companies and investors are well aware of the risks of offending sensibilities or running against the prevailing political winds in a host country.

Much of this is oil wealth accruing to governments with monopoly control over that resource in countries with less fluid systems for broadly disseminating that rising wealth. This stands in sharp contrast to our long tradition of widely dispersed entrepreneurialism, wealth creation, and private control of capital. Perhaps the over-arching question is whether more of the citizens in these countries will eventually call for a larger share of that capital to spend and invest as *they* see fit. For now, sovereign wealth funds seem to feel it's a buyer's market for focused investments across a range of global enterprises. That's probably not all bad. §

Entry Point for REIT Shares?...

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financial stress or serious liquidity concerns.

On the other hand, property prices in general still appear to be softening. The residential sector was hit hardest, with homebuilding off more than 40% from mid-2006 into early 2008. There's substantial unsold inventory of new residential units, and prices for existing homes are down 14% from a year ago. Commercial property rents can take longer to adjust, so the sector simply may have peaked later and be poised for a fall. That adjustment should be milder but could have further to run if the economy continues to struggle.

In fact, for the wider universe of REIT shares and real estate specialty funds it's probably a question of whether the real economy muddles through or suffers a deep downturn. For *investors* it probably comes down to whether one's portfolio *already* has a meaningful measure of diversified real estate exposure. §

Spouses' Expectations Often Differ on Retirement

Prepping for retirement isn't only about money. According to a recent study by Fidelity Investments, it's also about getting on the same page as your spouse.

Fidelity surveyed over 500 married couples who are within a decade of retiring. The results suggest that more than a third of the spouses differ markedly from their mates on what that lifestyle will look like. Issues of common disagreement include their respective planned ages of retirement and whether either or both of the spouses will continue to work in some capacity after retiring from a primary occupation. Overall, husbands appear to be a little more optimistic than their wives about their prospective retirement standard of living.

Steven P. Akin, President of Fidelity Personal Investments, said he was surprised that such issues remain unresolved for so many couples as they near retirement age. Maybe Mr. Akin is a bachelor. After all, on any given Wednesday a survey of married couples would probably find a lot of disparity between those spouses' plans for the upcoming weekend.

But seriously, developing a shared *vision* of retirement can help rationalize a host of other decisions, including saving, spending, and investment strategy. Working together on a written retirement timeline and a list of priorities might prove a useful, even *revealing*, exercise – maybe a good project for this weekend. §

Shoulders to the Wheel... *[continued from page 1]*

machine tools are capitalizing on the developing world's rising consumer weath and dramatic build-out of basic infrastructure, better housing, etc. Of course American farmers are benefiting from record commodity prices.

U.S. producers have had to sweat it out in a hotly competitive global market for years. They've pressed for greater efficiencies and tighter financial controls. Meanwhile production costs have been surging in China, India, and other emerging economies. Wages for engineers in India have jumped 20% per year, and even those call center workers we've come to know are getting fat pay raises. Feeling a similar wage-cost push, China recently pegged its year-over-year inflation rate at 7%. Prices are up in Indonesia, Thailand, and Vietnam which suffered a recent run of labor strikes.

That should translate into higher prices on imports for U.S. consumers. It may also be cooling those countries' interest in lending us back our dollars at rock bottom rates, only to lose ground on the currency exchange. Sovereign wealth funds have emerged as a symbol of the concentration of capital controlled by certain governments in Asia and the Middle East. They're buying American too, most notably through significant cash infusions for high-profile financial institutions (see related article on page 3).

Since the early 1990s much has been made of the symbiotic relationship between our high-wage, high-consuming economy, and the lower-wage, higher-saving developing world. That tune is modulating, with U.S. producers picking up some of the slack here while consumer spending accelerates elsewhere. That may be a trying adjustment for the U.S.; exports account for only about 12% of gross domestic product. Then again, *imports* only represent about 16% of GDP, and folks always seem to think *that's* a pretty big deal. §

If Only the Average Stock Picker Could Do This Well

The website *www.farecast.com* boasts a 75% accuracy rate in predicting whether airline fares for that trip you're booking will head higher or lower over the next seven days. The site considers your destination, travel dates, and industry trends. It also tells you whether the hotel deal you've lined up is any good. But what if the site's wrong? Well, at least you're not betting your whole retirement fund on the outcome. §

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