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Money

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Demand for wheat is stronger from countries such as India and China with growing populations placing strain on reserves

The pick of the investment crop

Agricultural commodities are the new route to riches, predicts a leading fund manager. **Paul Farrow** reports

Maverick fund manager Hugh Hendry is renowned for taking big bets and he reckons he has unearthed the next stock market phenomenon - corn.

It is why he is personally looking to snap up acres of agricultural land in Britain, so convinced is he that farms, for so long in the doldrums, will see an upswing in profits. It is also why his company, Eclectica has launched a global agricultural fund - the first of its kind in the UK.

Hendry is a ballsy manager who follows his instincts. In 2000 he was investing in gold long before its price surged, while in 2002 he upset rivals by flouting industry rules by sticking a third of his European fund in cash (80 per cent has to be invested in shares) because he feared the market was about to correct. It proved an inspired move. The market slumped and his fund - the only fund to make a positive returns in a 12 month period - winged its way to the top of the tables as it was. Jealous competitors complained Hendry wasn't playing fair - although the fund's investors thought differently.

Now Hendry's instincts tell him soft commodities, such as corn, whose prices have languished since the mid 1970s are set for a resurgence.

Bread prices have already risen 10p since September, according to a survey by the Economist Intelligence Unit in British Baker. The cost of biscuits and cake is also expected to increase.

"Inventories are low, supply growth has stagnated and demand is rising. We sense an opportunity. We have seen oil go from $10 to $80 and copper from 60 cents to $4 an ounce. If oil goes up to $160 a barrel you have only doubled your money but we are looking at making eight times your money," says Hendry.

He adds: "The market creates supply after the price has gone up - that's why dozens of property funds were launched after values had already risen sharply. Agriculture is the next copper and we can get exposure to it without paying top dollar - no-one else is doing it - it tells us we are in early."

Analysts agree that demand has increased for many agricultural commodities such as corn, sugar, palm oil, rape seed oil, coconut oil, soybean oil because the need for biofuels has increased. Demand will get stronger from the emerging countries such as India and China with growing populations placing strain on existing grain reserves. Furthermore, the emergence of a middle class in these countries is creating more demand for commodities associated with a higher standard of living, such as meat and dairy products. The Organisation for Economic Co-operation and Development predicts beef consumption in developing countries will increase by a third by 2015.

"It would have been understandable if the team doctor of the Chinese Olympic football squad, after seeing his team kicked, punched and intimidated out of a 'friendly' against the London soccer team QPR this year had blamed the thuggish behaviour of the English players," says Hendry. "Instead, he complained that the lack of beef and dairy products in his players' diet rendered them unable to stand up to such a physical challenge."

Hendry reckons the rising oil price has delivered the knock-out punch. Between 1975 and 2003, despite having deflated when measured against everything else, corn had kept its value relative to energy. The ensuing fivefold increase in oil, however, has changed everything, he says.

"Food has become so cheap relative to energy that making fuel from food seems like a good idea. US ethanol subsidies are stimulating demand and forcing prices higher. As corn prices rise and acreage is diverted away from wheat and soybeans, price inflation will spread across all agricultural commodities," he says.

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Hugh Henry: renowned for taking big bets

But Hendry's is not a sole voice. Schroders says the time is right for agricultural commodities and is why it launched a fund last autumn - although it is offshore, unregulated (no comeback from the Ombudsman) and invests mainly in futures rather than listed shares.

"Supply is constrained. Land available for farming is decreasing worldwide, due to issues such as urbanisation and desertification. Many agricultural commodities are experiencing record low stocks. Demand for wheat, for example, has exceeded production in six of the past seven years and reserves are extremely low," says Rodolphe Roche, the fund manager of the Schroders AS Agriculture Fund. "In contrast to the metals and energy sectors, very few agriculture prices have risen - historically this has been typical of commodity bull markets with agriculture lagging energy and metals."

Over the past five years, the Goldman Sachs Agriculture index has risen by 9 per cent, while industrial metals have soared 318 per cent over the same period. Energy has risen by 104 per cent and precious metals 105 per cent.

There are few ways for investors to get pure exposure to agriculture. Eclectica's Agricultural fund is the only UK regulated fund, while Schroders' can be sold only by qualified advisers. There are several general commodity funds that will invest in some agricultural stocks, while some ethical funds will invest in biofuel stocks. Some private client managers buy traded funds tracking individual soft commodities.

Goldman Sachs, the investment bank, offers two six-year plans linked to its Agriculture and Livestock indices. The first offers to protect your capital in full and gives 140 per cent of the rise in the index over the term. The second offers 180 per cent of any rise in the index but 100 per cent of any falls.

Hendry admits the fund is on the hunt for "big gains" and financial advisers agree it is investing in a volatile sector and is not for the faint-hearted.

Mick Gilligan at Killik, the stockbroker, notes that the GSCI (Agricultural) Index has fallen more than 50 per cent since 1996 and there are a number of drivers that could lead to a reversal of this trend. But he thinks agriculture should make up no more than 5 per cent - and perhaps only 1 per cent - of a balanced portfolio.

"Climate change appears to be leading to more extreme weather conditions which can have a negative impact on crop yields, and less predictable supply. The diversification argument for including soft commodity exposure in a portfolio is strong as the correlation between the FTSE All-Share Index and the GSCI index since 1975 is almost zero," says Gilligan.

But he says: "Unlike equities and fixed interest, it is very difficult to place a cashflow valuation on a commodity. Agricultural commodity prices may continue their downward trend and it may be difficult to generate positive returns from them, even with an actively managed approach."

Meanwhile, Matthew Wells an investment manager at Brewin Dolphin says it should be no more than 2.5 per cent of a portfolio but he is using it as an alternative asset. "Commercial property has been an alternative asset but is running out of steam and agriculture has good long-term growth prospects. Every year has a theme and it looks like it is agriculture this year. It has been on a long downward trend and we are using it as an asset that is not correlated to stock markets."