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Pension Funds Boosted By Oil

While Stocks Fall, Commodity Bets Are Paying Off

By David Cho
Washington Post Staff Writer
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Soaring fuel prices that are burning a hole in the wallets of consumers are not only benefiting oil companies and Middle Eastern producers. They are also lighting up the investment returns of pensions funds, which millions of ordinary Americans are counting on for their retirement.

California's public employees' pension fund, the world's largest, made its first investment of $1.1 billion into oil and other commodities early last year, and since then, Calpers has seen it soar 68 percent. Fairfax County pension managers have enjoyed a 61 percent return from a similar move over the past 12 months, far outpacing any other segment of the fund's portfolio.

"Our commodity investment has really helped," said Robert L. Mears, executive director of Fairfax County's Retirement Administration Agency. "This year would have been a lot worse."

Other pension funds are rushing to get in on the action as the prices of oil, precious metals, corn, uranium and other vital goods continue to reach record highs. Montgomery County officials are in the process of shifting 5 percent of their $2.7 billion pension fund away from stocks and into commodities.

These funds are part of a tidal wave of investment dollars that has flooded commodity markets in recent years and, critics say, contributed to the run-up in prices.

Investors, including pension funds and Wall Street speculators, have sharply increased their commodity allocations since 2003, from $13 billion to $260 billion, making financial actors an even larger force on these markets than farmers, airlines, trucking firms and companies that buy and sell the physical goods to run their businesses.

Pension funds are among the biggest of these financial investors, according to industry analysts, but the extent of their involvement has not been tallied.

These funds and similar investors buy futures contracts, which determine the price goods will fetch on a particular date in the future. Unlike commercial businesses, speculators have little interest in actually taking delivery of oil or other commodities. Instead, these investors trade the contracts like stocks.

The investments can be very attractive because there are only light restrictions on whether they can be bought and sold using borrowed money. While risky, this can produce enormous returns.

For decades, trading commodity contracts was considered taboo by most pension funds because the market is so volatile and risky. Most fund managers relied on their stock and bond investments to enlarge their pools of retirement money.

That changed after the stock market crashed in 2001. Fund managers realized they needed more diversified portfolios that would perform well regardless of whether stocks did. At the same time, new financial products simplified trading by allowing big funds to buy into commodity indexes, which work like mutual funds, that were run by Wall Street firms, mainly Goldman Sachs and Morgan Stanley.

Other investors also began buying commodities, including university endowments, hedge funds and big banks. But their investment strategy has been different than that of pensions funds. Many of these investors use trading techniques to make money when commodity prices both rise and fall, while pension funds mostly try to maximize their return over the long term by betting that oil and other commodities will increase in price well into the future. The approach adopted by pension funds has been a concern for some lawmakers because it pushes up prices by increasing demand for futures contracts.

The increase in commodity prices has been so sharp that some pension managers are worried about a possible crash. Partly for that reason, the Virginia Retirement System has decided to stay away.

"It's hard to know which commodities are in a bubble and which aren't," said Bob Schultze, director of the Virginia Retirement System.

Whether pension funds and other investors are behind the rise in food and fuel prices has sparked a heated debate on Capitol Hill and pitted powerful interest groups against one another. The airlines and other industry associations say the influx of investment money is creating a bidding war for commodity contracts and contributing to higher gas and food prices, hindering companies that need the goods for their businesses.

"The financial health and security of the United States depends, in part, on a commodities market that is stable, rational and predictable," Douglas Streenland, chief executive of Northwest Airlines told a House oversight subcommittee recently. "If the current pricing dynamic does not change, our industry will be severely challenged and will continue shrinking -- to the detriment of customers and the communities we serve."

Even as rising prices translate into staggering increases at the grocery store and at the pump, some regulators, including Treasury Secretary Henry M. Paulson Jr., say investors are not to blame. He has argued that the markets need them because they expand trading volume, allowing goods to change hands more easily.

Walter Lukken, acting chairman of the Commodity Futures Trading Commission, said the price of oil and other goods is going up simply because demand is outstripping supply. "It's our proposition that strong fundamentals are at play, driving higher commodity prices across the board," he said. "There are obviously powerful economic forces in play here: the falling dollar, political unrest in the Middle East, flat global production, rising demand from emerging world economies."

Lukken said his agency would study the issue nonetheless. He said he has formed a task force involving staff from the CFTC, Treasury and the Federal Reserve. Its report will be out in mid-September, he said.

But critics question whether long-term investors such as pension funds should bet on oil and other critical commodities.

"They were never designed for that. When you are buying food and energy commodities, it's affecting people's lives. There are social-justice issues," said Michael Masters, a hedge fund manager who has testified before Congress on the subject several times.

Pension managers counter that the public also has a stake in making sure retirement accounts are healthy. Commodities are one of the few investments that can perform well when inflation is rising.

In Fairfax County's case, no other investment came close to the returns of its commodity investment. Overall, its pension fund, which has about $5 billion in assets and serves 18,400 active county employees and 7,000 retirees, may show a very slight gain for the fiscal year ended June 1, officials said.

"Our job is to minimize our risks on the taxpayer," said Mears, the county's pension executive director. "If you can do that, why wouldn't you?"