MARKET LETTER

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Rough Rice

Dean Dordevic, principal, portfolio manager and analyst, shares his perspective on the global spike in food and energy costs.

It's eerily reminiscent of oil. The how-we-got-there part of our current four-dollar-plus per gallon fill-ups and the insult-to-injury credit cards that limit us to 75 bucks worth per SUV tank-full. (Do the executives of these companies not drive?) The parallels are seemingly undeniable: raw commodity prices that were too low for too long; near chronic levels of infrastructure underinvestment; and an industry that understandably shrinks and consolidates—instead of invests—to support whatever margin it can to grow or maintain its cash flows and dividends. The icing on the cake is the *"we're from the government and we're here to help"* ... crowd, which comes along with price supports and other incentives *not to create* new sources of supply. It's not oil we're talking about, but *agriculture.* What's been going on in the agricultural pits of late is getting very interesting. In our view, it's all the makings of another perfect storm. The winds are whipping things up, and since it seems that we've seen this movie before, we thought we'd share with you our review.

A very wise analyst in our industry once told me something I would never quite forget. He said that one of the great things about our industry is that you can know next to nothing about something one day, and be a near "expert" in only a very short while. I asked him how this was possible. He said it was all about something called *transportability.* Your analytical skills, he went on, once fully formed, were actually extraordinarily transportable, indeed malleable. A good analyst, he continued, can apply his skills to the analysis of different industries and asset classes and make very good decisions. Some are much better at this than others, he warned, but the speed with which you can ramp up will surprise you. Although I will admit to having questioned his premise over the years, I've come to believe that there's more than a kernel of truth in his wise words. While it is without a doubt a different and more complex game today, his basic premise has served to bolster the courage of my convictions on more than one occasion.

I count myself among the many analyst trainees who never for a moment thought that commodities would ever play any meaningful role in my daily thought process. As a young analyst trainee at E.F. Hutton & Company in 1981, I recall the commodities section of our thick spiral notebooks as a very thin section, something relegated to the back of the book. I remember spending perhaps one full day with a guy with a thick Brooklyn accent who showed up in a funny multicolored jacket with a big three-digit number on the back. To us he looked like a jockey about to mount Big Brown for a ride around Belmont Park. I recall translating what he said into something like ... "*commodities are not really investments, they are for a bunch of crazy people, located primarily in Chicago, who either make or lose spectacular sums of money, often with time horizons measured in only minutes or seconds. If you have any doubts about what I have just told you, remember they eat deep-dish pizza in Chicago ...*" 'Nuff said, I remember thinking. So here I sit, squarely at my computer terminal armed and ready, with one eye checking the latest news for food riots in Jakarta, and the other looking at the latest quote for RR U8 (9/08) ... or what is commonly known as the September contract for a commodity called *rough rice.* I am now an expert.

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We've reached a tipping point for food inflation. While this has certainly been exacerbated by the misguided rush to actually burn our food (i.e., ethanol), the reality is that this has only served as an accelerant. The root cause, much like the case for the supply and demand equation for oil, is the booming standard of living in the developing world. Says Morgan Stanley analyst Teun Draaisma, "*A combination of cyclical and structural factors has contributed to the boom in agricultural commodity prices. These include demographics (both population growth and urbanization), rising incomes, changing diets (more protein rich), high oil prices and the demand for biofuels, historically low inventories, political interference, and weather-related supply disruptions. Many ag markets are therefore at the pinch-point, where prices can go vertical in response to supply and demand shifts*."[1] While these commodities will remain extraordinarily volatile, with moves on the downside as spectacular as those on the upside, the important point here is that, much like we've seen in the oil patch, the changes required to ameliorate the structural imbalances will take time—most probably longer than we think. Of course, the swing variable is and will always be ... *price.*

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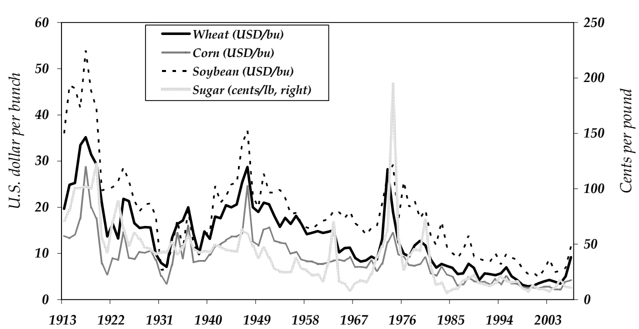
Agflation is creating both a *virtuous and vicious cycle* in many developing countries. In countries like Thailand and Indonesia, more than 40 percent of the work force is employed in agriculture. So higher food prices translate into higher farm incomes, higher living standards, and ultimately higher consumption of grains and meat.[2] As incomes go up, diets become more "westernized," and although the direct demand for grains decreases, the indirect consumption of animal feeds and grains soar; it takes 8 kilograms (kg) of grain to produce 1 kg of beef, 4 kg to produce 1 kg of pork and 2 kg per 1 kg of chicken.[1]

One significant difference between food inflation and energy inflation is the potential for a meaningful supply response. In other words, in theory it is not nearly as difficult to bring on more agricultural production as it is to find another new barrel of oil. What is indeed different now is that supply and demand are tighter across the board, so new supply would need to come from either more land devoted to crops or better yields from existing farmland.[1] But again, the key point here is that this will take time, and in the interim, these markets will remain highly vulnerable to supply/demand induced shocks. Another key difference is that while food inflation is hitting multi-year highs, inflation-adjusted agricultural prices are closer to the *lows of the last 100 years*.

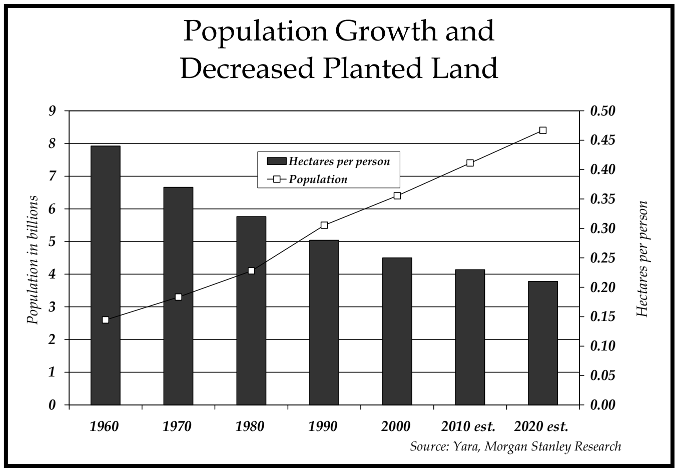
Inflation Adjusted Prices Still At Historically Low Levels



Source: CRB, Bloomberg, Morgan Stanley Commodity Research

There is another shift that has impacted pricing in these commodities as it has in others. Speculation has increased dramatically of late. According to the Commodity Futures Trading Commission (CFTC), open interest (number of contracts) in corn-related futures has increased more than fourfold since 2000.[1] Even more striking, agricultural commodity commitments are being increasingly viewed by many institutional investors as an *investable asset class*. Said Axel Hinch, CEO of Calyx Agro, a division of giant Louis Dreyfus Commodities, that is buying thousands of acres of cropland in Brazil, "*Huge pools of funds are being created to invest in agriculture. Their bet is that the demand for food will continue to increase, and these investments are earmarked for everything from the outright purchase of farmland to grain elevators and shipping equipment. While in the short run* *these investments will only serve to drive prices higher, longer-term these investments will boost food production and moderate prices. The world is asking for more food, more energy. You see it in huge demand. We will be helping to accelerate the development of infrastructure, and the consumer will benefit because there will be more supply."*[3]

There is perhaps no other commodity that is as globally politicized as food. In fact, for decades poor countries were discouraged from investing too much in agriculture. In an article in The Wall Street Journal, authors Joel Millman and Roger Thurow explain the paradox: Agricultural investments were seen as a problem rather than a solution to poverty. The economists' solution was to find anything other than agriculture as a means of income so that the world's poor could buy food rather than make it. But there's been a shift in that thinking. The World Bank's economists now see a healthy agricultural sector in poor countries as essential for a robust economy. *"In all my years that we asked for help, the answer was: no. Agriculture is not a tool for development, today it is,"* says Philippe Mathieu, a former Haiti agriculture minister. In fact, Haiti was once *self-sufficient* in rice production; however, due to the advice given by the World Bank and others, they became almost completely dependent upon imports. Haiti is now the world's largest importer of rice per capita and the number four market for U.S. rice growers.[4]



With deadly food riots becoming more common, food security is becoming part of national security. Costa Rica has embarked on a plan to aid subsistence farming. Mexico has its own version of this as well. Since the early 1980s the mantra from the World Bank and the International Monetary Fund was that poor countries could depend upon cheap food from the rich countries and should therefore focus their resources elsewhere. This advice failed to take into consideration that cheap sources of food would not stay cheap forever.[4] Said Thomas Friedman of The New York Times, *"The current global energy-food crisis is, understandably a pocketbook issue in America. But when you come to Egypt, you see how in a society where so many people live close to the edge, food and fuel prices become enormously destabilizing. If these prices keep soaring, food and fuel could re-shape politics around the developing world as much as nationalism or Communism did in their days."* He adds, *"The good news: More Egyptians today can afford to live like Americans. The bad news: Even more Egyptians can't even afford to live like Egyptians anymore."*[5]

By now we hope you are reasonably convinced that this is developing, "investable" and perhaps a long-lived theme. We believe that much like the case with energy, it is to be incorporated into our thinking from both a top-down (big picture) level, and a bottom-up investment selection level. Indeed, across our disciplines, we have at the moment exposure to DuPont (genetically modified seeds), FMC (insecticides, fungicides), ADM (corn processing, distribution), Caterpillar (farm equipment, machinery) and Terra Industries (fertilizer). However, food inflation is something that will continue to be part of our thinking as it relates to overall levels of systemic inflation. It will impact our thinking as it relates to our bond investments and asset allocation as well. Our hunch is that much like we watch the Dow and S&P 500 every day, for some time to come, we will be watching the perpetual contract for rough rice too.

Sources:
1. Teun Draaisma, Secker, Carr et al., "Agflation: Here to Stay," *Morgan Stanley Research Europe - Strategy: Euroletter*, May 6, 2008.
2. *Merrill Lynch Investment Strategy Asia Pacific*, "Rice to Riches," May 7, 2008.
3. Diana B. Henriques, "Food is Gold, and Investors Pour Billions into Farming," *The New York Times*, June 5, 2008.
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5. Thomas L. Friedman, "Letter from Cairo," *The New York Times*, June 15, 2008.

PROFESSIONAL PROFILE:
Shawn Narancich, CFA

When Shawn Narancich moved his young family back to Portland this spring, it was a personal and professional homecoming. He was delighted to join Ferguson Wellman as vice president of research and resettle in the city he and his wife Shelley had come to know a few years earlier. "We were in Portland from 2001 to 2005," says Narancich, "then we moved to Vermont. It's great to be back here, and to be a part of Ferguson Wellman."

From left to right: Nicholas, Shelley, Natasha, and Shawn
Photography by Bruce Beaton

Narancich is the newest member of the firm's research team. He follows domestic and international equities in the telecom and utilities sectors; provides assistance in tracking consumer staples; and has developed a recommended list of exchange-traded funds (ETFs) for use in client portfolios when appropriate.

Like every dedicated analyst, he devours information. "I read targeted pieces like sector research and individual company reports," he says, "as well as portfolio strategy, economic reports and, of course, The Wall Street Journal." Participating in weekly research calls and attending industry conferences are also part of the job. Gathering and processing information about the markets, industries and companies he covers helps him determine which investments make the best sense for Ferguson Wellman clients.

A Montana native, Narancich received BS degrees in accounting and business administration from the College of Great Falls; he also has his chartered financial analyst designation. His experience includes equity research and stock selection, portfolio management, corporate finance and strategic analysis. Narancich was an investment analyst at Chittenden Corporation and portfolio manager at Chittenden Bank in Vermont. Prior to the move to New England, he was senior corporate financial analyst at Stancorp Financial Group and portfolio manager at Wells Fargo in Portland. He began his career as an equity analyst at D.A. Davidson & Co. in Montana.

Narancich feels fortunate to have found his path early on. "An entry-level college business class piqued my interest in the stock market," recounts Narancich. "Soon after, I started investing on my own."

He shakes his head and laughs. "Wal-Mart was my first stock purchase," continues Narancich, "and I sold the shares too soon. I broke even, but the stock soared afterward. It was a great lesson in patience and the importance of experience. You have to go through some up and down cycles to see how companies go through stages. Earnings can continue to grow during a time when the stock price is going sideways."

Personally and professionally, Narancich couldn't be more pleased that his path has led him back to Oregon working for Ferguson Wellman. "Since day one, Ferguson Wellman has been a good fit for me," he says. "The people are great, the firm's work ethic is strong, and the environment is very collegial. It's also wonderful to be back in the Northwest."

As they wait to sell their house in Vermont, they continue to look for a house to buy in Southwest Portland. In addition to house hunting, Narancich and his wife Shelley are reacquainting themselves with Oregon and sharing new adventures with their son Nicholas, who is four, and daughter Natasha, who is almost two. Their current favorites: city parks, the Children's Museum, OMSI, the coast, and visits with extended family in the Portland area. Once the family is settled in their new home, Narancich plans to teach Nicholas how to play golf and fish.