The Kindness of Commodities

Although Morningstar places Oppenheimer's Real Asset Fund in the natural resources category, during our interview with lead manager Kevin Baum, Ticker learned that the fund goes beyond investments in instruments such as crude oil and natural gas. In fact, the fund takes a long-only approach to the commodities futures markets. That strategy produced a return in 2002 of 27% and a first-place ranking, according to Morningstar, among the 72 funds in its category. Baum, however, is emphatic about telling advisors who invest in his fund that they should use it as a complement to their overall asset allocation strategy.

Q: Investors who have stayed with your fund since inception have a chance to break even. To what do you credit the turnaround in the past 18 months?

A: You bring up a couple of interesting points about returns since inception versus returns in the last 18 months. I think that speaks to a couple of key features about this fund. We strongly believe in rebalancing. We think of the long-only commodities exposure we provide as a unique, separate asset class. We position this fund as an asset allocation tool to be used with both stocks and bonds. The historical data bears this out. It makes sense to rebalance periodically. People that dollar-cost averaged, or were in the fund since inception and then rebalanced up to their original exposures a year or two ago have enjoyed a nice run. The big part of the strong recent performance has been a function of strong commodity markets. We're always on the long side of these markets. Rising commodities prices, as we've seen lately with gold and oil, is good for the Real Asset Fund.

Q: You're telling me that since you only take the long side of a trade, this means you don't sell short futures contracts.

A: Correct. It's similar to the typical mutual fund where you might find a growth or value fund that's always on the long side of the market. Similarly, we're on the long side of the commodities markets. We may underweight a certain commodity or a certain sector, but we're still on the long side. I should mention one important distinction between our fund and a typical equity-based natural resources fund. Clearly, those funds are investing in stocks like Exxon-Mobil or Phelps-Dodge, and you're clearly getting an exposure to corporate management, accounting and the broad stock market. With our product, the instruments we're using are directly tied to the performance of the underlying commodity prices. That's really where the diversification benefits are. It is a distinct asset class that is negatively correlated with stocks and bonds.

Q: On the front page of the annual

Oppenheimer Real Asset A		
Fund Facts		
Symbol	QRAAX	
Website	www.oppenheimerfunds.com	
Address	Oppenheimer Funds, P.O. Box 5270, Denver, CO 80217-5270	
Tel. No.	800-525-7048	
Inception	03/31/97	
Portfolio		
Total Net Assets *		$141.00
Avg Mkt Cap ($ Weighted) *		---
Average Price/Earnings Ratio		---
Average Price/Book Ratio		---
Turnover Ratio		49.00%
Investment Information		
New Investment		Open
Min Initial Investment		$1,000
Min Subsequent Investment		$25
Min Initial IRA Investment		$250
Risk (Against Std Index - 3-yr Average)		
	QRAAX	Category Avg.
Alpha	5.63	15.33
Beta	0.07	0.73
Returns vs. Lipper Natural Res Fd Index		
	QRAAX	Index
1 Year (Cum.)	42.86%	-7.16%
3 Year (Ann.)	8.79%	2.02%
5 Year (Ann.)	1.01%	2.13%
Returns vs. S&P 500		
	QRAAX	Index
1 Year (Cum.)	42.86%	-23.02%
3 Year (Ann.)	8.79%	-13.84%
5 Year (Ann.)	1.01%	-1.33%
Fees and Expenses		
Max Sales Charge - Front		5.75%
Max Sales Charge - Deferred		0.00%
Redemption Fee		0.00%
Total Expense Ratio		1.51%
* millions		Data through: 01/31/03
Source: Company Documents; Lipper		
Portfolio Manager		
Kevin Baum		05/01/99

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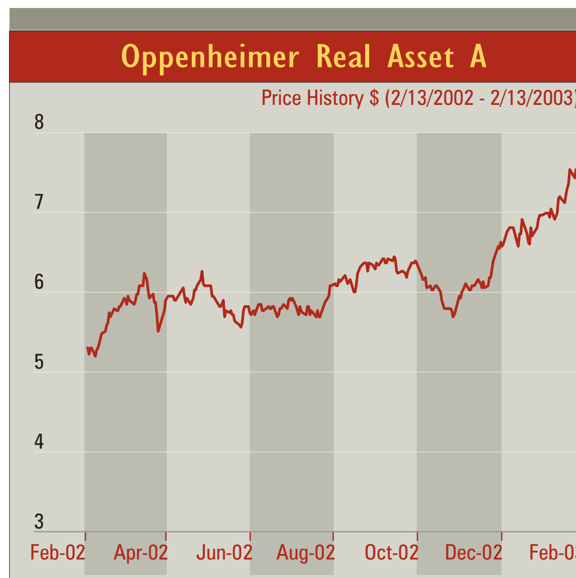
report, there's a quote by your co-manager, Angelo Manioudakis, that reminds me of George Soros' investment strategy: "These trades are intended to exploit perceived price inefficiencies within a specific commodities sector." Do you employ a similar strategy?

A: I should take a half-step back and cover a little of the product structure before I directly answer the question. Again, this is a long-only commodity product that is benchmarked to the Goldman Sachs Commodity Index. We try to deliver product integrity to the investor so that when they put a dollar into the fund they can expect a dollar in commodity exposure, which is really what the fund is all about. We are actively managed, which gets back to your question. We are of the belief that markets are not completely efficient, and tend to act irrationally. We've seen that in all markets over time. What we try to do is identify what we perceive a fair value for a commodity or sector to be, identify whether there is a mispricing, and identify whether market exuberance has taken things to an extreme one way or the other. We try to identify catalysts that can cause or impact a reversion to what we perceive fair value to be.

Q: I can understand the fear about disruption in oil supplies due to a military conflict in Iraq. The same applies to gold. Other analysts are saying gold's rise is due to fears of inflation. Central banks, particularly in the U.S., have been printing money in order to reflate prices. What's your view?

A: That's certainly a possibility. While there has been a lot of talk in past months about deflation, I think it's quite possible that if you look out two years, we could find ourselves in a situation where, with the monetary and fiscal stimulus that I think we're seeing, in the U.S. and globally, it's certainly within the realm of possibility that this reflation trend could reappear. That would obviously bode well for commodities, especially commodities relative to other asset classes. Your point about gold and what factors are driving it, there is unquestionably common threads that affect all sectors of the commodities markets. Whether it's risk premium, or geopolitical risk, or a declining U.S. dollar, there are certainly several factors that weave their way through most of these commodity markets.

Q: When the lay investor thinks of commodities, he usually refers to corn or gold. How does a professional view this term?



A: That's an interesting question. My definition for commodities and how we define it in the Real Asset Fund is there are consumable and transformable commodities. What we're talking about are things like aluminum that can be transformed into another material, or corn, which can be consumed. We don't include currencies or other instruments that are often times categorized as commodities.

Q: You mentioned that you don't trade in currencies, even though they are consumable and transferable. Can you tell us why not?

A: Again, going back to the long-term returns to what we define commodities as real assets to be, we know that they've provided average annual returns of 11 to 12% a year. That's because, again, what's common to the commodities markets is that they give you collateralized positions so that you're earning that coupon return, or coupon yield. But also with commodities, there is typically an imbalance between producers' desires to hedge price risk and consumers' desires to hedge price risk. What I mean by that is that commodity producing companies have a desire to move some of the price risk off their balance sheets, so they're looking to sell forward some of their production. You and I are the ultimate consumers of gasoline. Typically we are not hedging our forward consumption. So you have an imbalance between the producer's interest and the consumer's interest. That really creates an opportunity for a long-only investor to step in and to be paid a premium, effectively, by those commodity producers to accept that price risk. That helps to generate some of these strong positive returns over time from being on the long side of the commodities markets. The currencies don't really share that quality. Not only do they have different return properties, but also I think that one other important distinction I should make is to examine the diversification properties that commodities can provide. For instance, what we're seeing right now is how rising energy prices can be detrimental to financial assets, stocks and bonds. We're trying to offer commodities in a product with just a 10% asset allocation framework to generate positive returns - and returns that also are unique from stocks and bonds.

Q: The fund has an exposure to fixed-income instruments of roughly 60%. Is this done to provide a cushion?

A: What the fixed-income instruments are doing is to enhance our yield and to generate some incremental

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returns within a diversified basket. At the end of day, we've a very low duration, almost zero duration on these fixed-income instruments, plus or minus half a year, usually. That's where our co-manager, Angelo Maniou-dakis comes in. He runs a couple of funds for our fixed-income team. He treats our fixed-income securities no differently than he would the high-grade securities that he's buying for other funds. It's a highly diversified basket of fixed-income securities that are rated investment-grade. We're referring to government agencies, triple-A and double-A corporates, and high-grade mortgage-backed securities. You're not investing into a product that has a lot of interest rate risk.

Q: When and why should investors look to invest in your fund?

A: As we've mentioned many times to advisors who use this fund, this is meant to be a complement to stocks and bonds. If the stocks and bonds are performing very well, your portfolio is going to perform quite well. This product is intended to be there to deliver the diversification benefits when you need it most. It probably is worth pointing out that when you look at years when stocks have been down. In the last 30 years, stocks have been down in eight instances, while commodities have been up, and up pretty strongly, in fact, in six of those eight years. The bond market was down on seven occasions and in those seven years commodities have been up. It really does do what it's advertised to do, which is to provide some protection for your stocks and bonds.

Q: I think a commodities-based fund would tend to be more volatile over a 12-month period. How can you build wealth for shareholders over a five to ten year horizon?

A: I'm glad you asked that question, because you're right in one respect. If you look at the asset class and you view it over a 32-year period, from 1970 to 2002, it has been two or three percentage points more volatile than the U.S. stock market. But that volatility actually is little counter intuitive. That volatility is a good thing because of the negative correlation. We're negatively correlated to both the stock and the bond markets. In an asset allocation framework, which combines what we advocate as a 10% allocation to the Real Asset Fund, when you combine that allocation with your stock and bond exposure, you see a pretty sharp reduction in total portfolio volatility. How I answer that question to people is that this isn't designed to be a standalone investment product. It's designed to be a complement to the stock and bond portions. When you view it in that light, it actually lowers the volatility of your portfolio. As to your question about long-term returns, this actually surprised me. When you again go back to 1970, the annualized returns on commodities to the asset class have been on par with the S&P 500. So, you're getting these powerful diversification benefits without having to sacrifice long-term returns.

> *"We position this fund as an asset allocation tool to be used with both stocks and bonds. **It makes sense** to rebalance periodically."*

About:

Kevin Baum is currently a portfolio manager of the Oppenheimer Real Asset Fund. Mr. Baum joined Oppenheimer Funds in 1993. During his tenure, he has worked in security analysis and trading for the fixed income department before becoming a portfolio manager. He has been a commodities analyst and trader for the Real Asset Fund since its inception. Prior to joining Oppenheimer, Mr. Baum worked for two years at Edward Jones. Mr. Baum received his B.B.A. in Finance from Texas Tech University. He is Series 3 and Series 7 licensed and has obtained the Chartered Financial Analyst designation.

Q: Do you mostly access in-house research or rely more upon outside sources?

A: It's a combination of both. We do have a staff that analyzes specific commodities and sectors. But we also use research provided by Wall Street firms as well as trying to leverage some of the relationships we have with commodity producers. We're in contact and have a running dialogue with those folks and use some of their ideas. We do have proprietary trading models in which we try to capture all these fundamental and technical factors and that's obviously done within the shop.

Q: You're talking about fundamentals as it relates to commodities. Can you describe how this term differs compared to evaluating public companies?

A: To take another half step backwards, you brought up the contrast between fundamentals of commodities and stocks, that's actually a very important feature that drives the diversification benefits that commodities offer. We know stocks are financial assets and tend to be forward looking. We're taking a stock and trying to evaluate what it's future cash flows are going to be and then discounting that back at some rate. Commodity prices are typically more concerned with the current environment for supply and demand and inventories. That's what drives a lot of diversification benefits and leads to the performance of the different asset classes at different points in the business cycle. With commodities, what we're doing is focusing on what our current inventory situations are, what demand and supply are in the coming months. It's a little bit different in that you're not trying to look out three or four years for projected cash flows. ▮

Dave Jennings

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