

Playing the Return of Commodity Pricing Power

By AVI SALZMAN

One natural-resources fund manager is taking a shine to zinc and met-coal stocks, among others.

COMMODITY COMPANIES RANGING from oil and gas explorers to zinc miners cut back severely on capital projects to survive the global downturn, spending less on drilling and mining for new resources. Now, demand is ramping up, and in areas where supply is tight, commodity prices are flying high. Money manager Frederick Sturm, the manager of Ivy Global Natural Resources Fund (ticker: IGNAX), spoke to us about where he sees the best investment opportunities.

Barrons.com: Where is the market headed for commodities?

Sturm: I think the first and most important point is that the central banks have succeeded at moving the markets past an inflection point in this inflation-deflation debate. And I believe that we are seeing pricing power restored to a number of industries that are properly structured.

You read the headlines and you are hearing about debt pressures in America, debt pressures in Greece, restructuring in Dubai, and you feel that the road ahead of us is still very hard. And then the next day you see that iron-ore companies are increasing their prices by 90% year over year, that coke and coal companies are increasing their prices at 55% because the economy is running faster than perhaps the supply lines are able to keep up.

We have laid out now over the past 15 years this premise that as the world keeps growing, keeps industrializing, keeps inflating by population, that there could come a time where we'll really struggle to supply all the world needs.

By our models, we still suspect that as we get into the middle of this decade that commodity prices generally will dou-

ble coming out of 2009. We don't mean a mathematical double across the board. What we mean is that prices will once again need to rise to levels that pinch off demand because supply will be insufficient to provide all that is asked for, and we are already getting these early markers in more diverse areas than we might have thought. We are getting it in iron ore. We are seeing that pricing power in coke and coal. We are seeing the pricing power in cocoa, and we even saw it in garlic prices last year.

Do you think that it has to do with global economic growth being more robust than people had expected?

There are a number of different elements to it, but we are arguing more tactically that the most important unintended consequence of the shutdown of capital markets is that we have all rightsized our companies, run them to survive tomorrow and not invested for a period of growth a couple of years out. In some industries that is not a big risk to the supply lines because you can quickly restart a plant. But if you have extractive industries where the underlying productive capacity is diminishing, if you don't keep reinvesting at some point you start running out. An example within the mining industry would be zinc mines. Zinc has been one of the less-favored metals. The industry is not well rationalized. There are other industries that are structurally tighter like copper. Because of a lack of investment in new mines, we estimate that as we get to the middle of this decade as much as 15% of the global mining capacity will be shut because you will have depleted the mines. That is one good example of a potential mismatch between a world that can and

Manager's Bio



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will grow again, and an underinvestment in the supply.

How does an investor play that?

There are a number of companies around the world that have zinc exposure. One for instance would be Teck Cominco [now known as Teck Resources (TCK)], one of the world's largest providers of zinc.

Are you particularly bullish for all commodities in the next year or would you say that you have to pick and choose?

We believe that the industries that have already displayed the strongest pricing power are the ones that will sustain that pricing power through this year and probably into early next year, and only as the Western economies begin to improve will you then see a broadening out into the other commodities. So copper has been and is still better than aluminum. Oil has been and is still better than natural gas. Pulp is better and still will be better than newsprint. At some point later this year, as we enter into 2011 we believe there will be an opportunity for investors to rotate into the commodities that have lagged, but we don't think now is a preferred time to do that.

(over please)

Why not bet on the laggards?

The most important consideration is the underlying structure of the industry and the tightness on the supply lines. Our perspective is that the world this year is going through a transition from government spending and interest-rate-driven push to consumer spending and business spending pull. And in that transition, we are not yet at a point where we are running full tilt in the global economy. It leaves us concluding that there will still be haves and have-nots. What we are really interested in is staying with the companies that are creating wealth day by day through their profit margins – the best way for us to measure that is pricing power.

How would you play those sectors? What kinds of companies and what companies in particular?

The company that stands at the top of our list is Alpha Natural Resources (ANR), an American-based company that has been until now the largest producer of metallurgical coal. Who would have thought 10 years ago when China was exporting coal to the world that now it is America exporting coal to China.

Any other companies that stand out?

Yes, we have been proponents of the infrastructure assets in the energy business like pipelines. That sector has had a very good run over the last year and a half, and it is perhaps not fully priced but is now more fairly priced from discounted levels.

After the run-up in the stocks, are these pipelines still worth investing in?

One of the areas that has been somewhat overlooked by investors we believe is the hybrid companies that are part pipelines and part natural-gas producers. An example of that is El Paso (EP), which has the most formidable natural-gas-gathering transportation system in America. An assessment of the sum of the parts doesn't give that company fair value.

Do you expect natural-gas prices to steadily improve or to stay at their levels for a little while?

We still think that there could be as much as half a year of natural-gas prices staying low, but we are hopeful that as we get into the winter season for next year that natural-gas prices will begin to improve.

You mentioned a few other commodities, including iron ore. Which companies do

you favor there?

One of the companies that is more levered and has screened out fairly well is Rio Tinto (RTP). Rio Tinto is one of the world's largest producers of iron ore and proportionally will benefit more than some of the other larger mining companies from the increase in iron-ore prices. Given our expectation for sustained stronger iron-ore prices, the cash generation for Rio Tinto is still not fairly valued in the market we believe.

Thank you.

Investment Philosophy

In managing Ivy Global Natural Resources Fund, Sturm focuses on both growth and value, as well as utilizing both a top-down (the creation of macro-economic models to prepare an outlook for economic and market conditions) and a bottom-up (fundamental, company by company) approach. For individual security selection, Sturm maintains models for hundreds of companies worldwide in sectors including integrated energy, chemicals, steel, forest products, base and precious metals, coal and uranium, and agricultural commodities.

Fund Performance as of 06/30/2010	Quotron Symbol	Class Inception	1-Year	3-Year	5-Year	10-Year	Life	Expense
Class A (NAV)	IGNAX	01/02/1997	4.72%	-13.04%	4.22%	11.70%	9.56%	1.40%
Class A (Load)	IGNAX	01/02/1997	-1.30%	-14.74%	2.99%	11.04%	9.08%	1.40%
MSCI ACWI Energy/Materials Index	—	—	13.45%	-7.68%	8.02%	9.81%	—	—
MSCI Commodity Related Index	—	—	15.65%	-2.53%	10.50%	12.94%	—	—

Data quoted is past performance and current performance may be lower or higher. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Please visit www.ivyfund.com for the Fund's most recent month-end performance. Class A share performance, including sales charges, reflects the maximum applicable front-end sales load of 5.75%. Performance at net asset value (NAV) does not include the effect of sales charges. MSCI ACWI (All Country World Index) 55% Energy / 45% Materials index is a custom made index that is a free float-adjusted market capitalization weighted index that is designed to measure the energy and materials equity market performance of developed and emerging markets. MSCI Commodity-Related is an unmanaged index comprised of securities that represent the commodities sector of the stock market. It is not possible to invest directly in an index.

Consider All Factors. Investing in companies involved in one specified sector may be more risky and volatile than an investment with greater diversification. International investing involves additional risks, including currency fluctuations, political or economic conditions affecting the foreign country, and differences in accounting standards and foreign regulations. These risks are magnified in emerging markets. Investing in natural resources can be riskier than other types of investment activities because of a range of factors, including price fluctuation caused by real and perceived inflationary trends and political developments; and the cost assumed by natural resource companies in complying with environmental and safety regulations. Investing in physical commodities, such as gold, exposes the fund to other risk considerations such as potentially severe price fluctuations over short periods of time. These and other risks are more fully described in the prospectus. Not all funds or fund classes may be offered at all broker/dealers.

06/30/2010 equity holdings as a percentage of net assets: Alpha Natural Resources, Inc. – 5.0%; Rio Tinto PLC – 1.4%; El Paso Corporation – 3.1% Teck Resources – 1.4%.

The Fund is subadvised by Mackenzie Financial Corporation, an unrelated entity.

Investors should consider the investment objectives, risks, charges and expenses of a fund carefully before investing. For a prospectus containing this and other information for the Ivy Funds, call your financial advisor or visit us online at www.ivyfund.com. Please read the prospectus carefully before investing.

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