Navaneel Ray, Managing Director, Equity Investments

Natural resource funds can offer investors another road to long-term growth outside the broader equity and fixed-income markets. Moreover, these funds provide U.S. equity investors with portfolio diversification benefits and exposure to global economic growth.

TIAA-CREF’s recently launched Global Natural Resources Fund provides investors with the opportunity to participate in the growing global market demand for natural resources, which is being driven by infrastructure investment and rising consumption in developing countries. Navaneel Ray, Managing Director Active Equity Research, answers some frequently asked questions about investing in natural resources funds.

What is a natural resources fund?

Navaneel: A fund that invests in securities related to natural resources sectors including energy, metals, materials, agriculture as well as companies in associated sectors like mining equipment, oil services, agricultural chemicals, etc. We define natural resources as raw materials before and after processing, but before brand value addition, for example crude oil, natural gas, minerals, steel, agricultural products and chemicals but not branded food or fabricated items.

What are the benefits of investing in natural resources funds? What makes them attractive to investors?

Navaneel: Natural resources equities provide exposure to infrastructure development and rising consumption in developing countries, driven by growing populations and rising affluence. Historically, the performance of commodities and commodity-linked equities has had low correlation with other components of a diversified U.S. equities portfolio, improving the benefits from diversification. In addition, commodities and natural resources equities may serve as an inflation hedge within a diversified portfolio, to protect against loss of purchasing power. Finally, commodities and natural resources equities tend to have a negative correlation with U.S. dollar exchange rates, and thus provide protection against a weakening dollar for U.S. investors.

What are some of the risks associated with investing in natural resources funds?

Navaneel: Risks may include some or all of the following: market risk, issuer or financial risk, industry/sector risk, non-diversification risk, active management risk, foreign investment risk, emerging markets risk, political risk and special risks of investing in natural resources.

Generally, natural resources equities are more volatile on a daily basis and have higher headline risk than other sectors as they tend to be more sensitive to economic data, political and regulatory events as well as underlying commodity prices. Commodity prices themselves have become more volatile in recent months due to investment fund flows in and out of the sector that are not linked to fundamental demand and supply.

With commodity prices taking a bit of dip these days, is it a good time to invest in natural resources funds?

Navaneel: We think so. Demand for natural resources is being driven by growth in developing countries, where population growth and rising standards of living are translating into growing demand for resources. This is a long-term trend that should continue, despite short-term market volatility. The world’s supplies of oil, copper, iron ore, food grains and other essential natural resources are being depleted and should remain constrained for the foreseeable future. Access to scarce natural resources should provide commodity producers that possess the resources, with sustainable pricing power, leading to attractive risk-adjusted returns for the sector.
What are the drivers behind the current boom in natural resources?

Navaneel: Demand for natural resources is being driven by infrastructure investment and rising consumption in developing countries. At the same time, there has been prolonged underinvestment in the resources sector and related industries. Rising production costs are being driven by the following:

- Limited supply caused by declining resources at producers and lack of new finds
- Equipment shortages
- Shortage of workers, higher wages and strikes
- Increased government taxes and royalties
- Environmental considerations
- Infrastructure constraints

The supply response is taking place now but has been surprisingly slow despite the rapid rise in commodity prices. The critical issue is not whether supply is growing but when supply will be able to actually overtake demand. Commodity resource companies have just begun to develop tremendous pricing power as supply sources begin to get exhausted.

Do you see any differences between this cycle and previous cycles?

Navaneel: This cycle is unlike previous cycles for a number of reasons. First of all, structural changes are occurring in the global economy as China, India and the other emerging economies have become the primary drivers of demand for commodities and are compensating for any slack in the Organisation of Economic Co-operation and Development (OECD) economies. Secondly, the natural resources sector is more consolidated now than it was in previous cycles, which has contributed to producer discipline. Within the energy sector, national oil companies’ (NOC) dominance of global oil production has increased significantly.

Another feature of this cycle is the current theme of U.S. dollar weakness, which is likely to sustain. Also, significant monetary easing in the Western world should drive commodity price inflation. Finally, some of the cost inflation for resource production might be permanent. Cost inflation is 20%-30% per annum currently and significant cost overruns on new projects have become the norm.

What are some of the current challenges facing these types of funds?

Navaneel: The natural resources sector tends to be more volatile than other equity sectors for a couple of reasons. First, natural resources equities are influenced by the price of underlying commodities like oil, gas, metals, coal, etc., several of which trade on various exchanges and have price fluctuations based on short-term dynamics partly driven by demand/supply and nowadays also by investment flows. Secondly, natural resources equity prices tend to react more sensitively to global events and economic data than other sectors, whether it is a natural disaster like an earthquake, political upheaval in the Middle East or release of employment data in the U.S.

While the natural resources sector tends to be more volatile than most other equity sectors, this presents both a challenge as well as an opportunity. Historically higher daily volatility risk has been compensated by better longer-term rewards for shareholders. We believe that a patient, disciplined, long-term investing approach is essential for making money in this sector.

What factors should you consider before investing in natural resources funds?

Navaneel: You should consider a number of factors including but not limited to your investment time horizon, risk appetite, volatility threshold and other factors related to your current asset allocation in conjunction with your investing goals and objectives.

What is TIAA-CREF’s philosophy in investing in this asset class? What are your investment themes?

Navaneel: We seek to invest in the best-positioned companies globally that will continue to disproportionately benefit from growing demand for limited resources. We are agnostic to geographical locations when picking our investments and tend to favor companies that are resource-rich, have growth potential and trade at attractive valuations. By incorporating emerging markets into the analysis, we create a broader canvas of investable stocks, as some of the world’s largest resource companies, particularly within the energy sector, are located in emerging markets. Also, our fund
will generally be more balanced and offer a broader exposure to the natural resources sector as the benchmark for the fund, the MSCI ACWI Commodity Producers Sector Capped Index, is a sector-capped benchmark, with equal weights in agriculture/energy/metals sectors. One issue with market capitalization-weighted natural resources equity indexes has been that they get completely dominated by energy stocks.

Our recently launched Global Natural Resources Fund is a play on two key themes: demand for natural resources driven by continued economic and population growth in developing countries, and improving pricing power for commodity producers derived from a growing scarcity of resources.

What is the outlook for the asset class? Where do you see the most growth potential for investors?

**Navaneel:** The short-term performance could remain volatile for a while due to concerns about slowing economic growth and political uncertainty in Europe and in the U.S., but the long-term outlook for the asset class remains strong as the fundamental drivers of demand growth are more dependent on economic growth in emerging markets than in the OECD economies. Moreover, supply constraints are likely to sustain, supporting the profit outlook for existing resource holders and producers. For investors with a long-term focus, investing in a natural resources fund has the potential to deliver attractive risk-adjusted returns over time.

Do you have any take-away points for investors?

**Navaneel:** The fundamental long-term trend of the growing scarcity of natural resources, resulting in greater pricing power for commodity producers, remains intact, despite day-to-day volatility in the financial markets. TIAA-CREF's Global Natural Resources Fund offers the opportunity to benefit from this trend by investing in companies that are positioned to profit from the ongoing commodities boom. The key differentiators for this fund are its global framework, emerging markets exposure and the sector-capped nature of its benchmark combined with TIAA-CREF's experienced research team that has been successful investing money in the same sector for the past five years.

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(1) Over the past 10 year-period ended 11/23/11, the weekly correlations of various benchmarks to the S&P500 have been as follows: Russell 1000 (99.9%), Russell 3000 (99.7%), MSCI ACWI (94.2%) and MSCI ACWI CPSC (77.5%).

(2) Over the same 10-year period, the annualized standard deviations of the various benchmarks were: S&P 500 (19.1%), Russell 1000 (19.3%), MSCI ACWI (19.2%) and MSCI ACWI CPSC (26.3%).

(3) The total return for the past 5-year and 10-year period ended 10/31/11 for various indexes have been respectively: S&P 500 (1.3%/43.7%), Russell 1000 (2.8%/50.6%), Russell 3000 (2.9%/53.8%), MSCI ACWI (1.5%/38.3%), MSCI ACWI CPSC (32.9%/257.6%). Past returns are no indicator of future expected performance.

Diversification is a technique to help reduce risk. There is no absolute guarantee that diversification will protect against a loss of income.

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