

July 12, 2010

Jack Ehnes, CEO
Christopher J. Ailman, CIO
California State Teachers' Retirement System

Dear Mr. Ehnes and Mr. Ailman,

We write as organizations like yours who know that our investments serve not only to benefit our own organizations, but can also be used to serve the greater community as well. We appreciate your use of shareholder resolutions to help corporations decrease their participation in global warming and other important themes.

We write with concern about your recently announced decision to invest part of your portfolio in commodities.¹ We believe that large institutional investments in commodity futures markets have contributed to the excessively volatile prices in food and energy commodities in recent years and have detrimentally affected those markets.

These effects were most vividly seen in 2008 when prices skyrocketed to record highs to then radically fell to unexplainable lows. The global effects of the food and oil bubbles of 2008 were disastrous. An additional 130 million people (UN estimate) were driven to hunger by the high food prices that year. In dozens of countries where chronic hunger is a long term reality, the situation grew so desperate that spontaneous food riots sprung out. Many of our organizations work directly with the marginalized communities around the world who were most severely affected by the food crisis.

We are convinced that institutional investments in commodity futures have interfered with the functioning of these important markets and are asking investors to reconsider maintaining commodities as part of their portfolio. **We urge you to not add commodities to the CALSTRS portfolio.**

In the last five to ten years, a growing number of institutional investors have shifted large sums of money into the commodity futures markets. While small percentages of each investor's overall investments, cumulatively they represent hundreds of billions of dollars flowing into relatively small commodity markets.

Christopher Johnson of Reuters reported that "Pension funds and money managers have tripled their holdings in commodities markets since 2007, industry data show, with \$250bn to \$300bn now invested by passive long-only funds."² According to testimony from hedge fund manager Michael Masters to the Commodity Futures Trading Commission (CFTC) on March 25, 2010, "In 1998, the average commodity derivatives market was about 25% speculative as a percentage of open interest. By 2008, speculators comprised about 65% of open interest. Bona fide physical hedgers once outnumbered speculators 3 to 1; now speculators outnumber hedgers 2 to 1. The positions of bona

¹ Big US pension fund moves into commodities
<http://www.ft.com/cms/s/0/0a034cec-6fb9-11df-8fcf-00144feabdc0.html>

² Commodities bubble likely, analyst says, Feb 5, 2010
<http://www.nationalpost.com/related/links/story.html?id=2524046>

vide physical hedgers doubled during this ten-year period, while the positions of speculators rose by 1200%.”³

As part of its study of speculation in wheat markets, the Senate’s Permanent Subcommittee on Investigations interviewed a large number of farmers, grain elevator operators, and grain market analysts. “Virtually all of the grain traders and many of the market analysts provided the Subcommittee with the same explanation for the large, persistent difference in Chicago wheat futures and cash prices (basis), and for the failure of those prices to converge as the futures contracts near expiration. These grain traders and analysts stated that the most significant factor contributing to the increasing basis and the lack of price convergence was the large presence of commodity index traders in the Chicago wheat futures market. Many traders stated that index traders had created an additional demand for futures contracts that was not related to or matched by any corresponding demand in the cash market, and that the futures prices had responded to this added demand by rising to a higher level than the prices in the cash market.”⁴ Please see the list below for other studies showing the dramatic effect that excessive speculation has had on commodity markets in the last five years.

We believe that the commodity futures markets were created for two principal purposes: to allow producers and consumers of physical commodities to hedge and to define the market price for commodities. Investments in commodities through commodity indexes or exchange-trade funds destroy both of these key functions of commodity markets. These passive investments maintain their positions, via continuous rolling, for long periods of time. They therefore consume liquidity instead of providing more liquidity as traditional speculators do.

Passive investments throw off the price discovery function of futures markets for two reasons. First, they tend to be long-only investment vehicles and therefore tend to push prices up.⁵ Second, because buyers of index funds base their buying decisions on asset allocation and rebalancing their portfolios, instead of on the supply and demand conditions of specific commodities, they throw prices off from their natural balance.

“In summary, passive investors compete with physical commodity consumers and make it much more difficult for them to hedge. Their buying and selling greatly damages the price discovery function of the commodities derivatives markets. They provide no benefits whatsoever to the markets because they consume liquidity. And most importantly, they drive up commodity prices, which hurt everybody on the planet.”⁶

Commodity returns not living up to theory

Beside the negative global effects of commodity indexes and exchange-traded funds, these investments have not nearly lived up to their early promise as an investment tool. While a famous

³ From testimony by Michael Masters to the CFTC, March 25, 2010

⁴ Excessive Speculation in the Wheat Market, Majority and Minority Staff Report, Permanent Subcommittee on Investigations, U.S. Senate, June 24, 2009, pg. 138.

⁵ The more recent phenomenon of actively managed commodity indexes, while perhaps offering a better return for investors, will still destroy the price discovery function of the markets due to the fact that large amounts of money will be placed by investors trying to balance their portfolios, instead of based on supply and demand conditions of specific commodities.

⁶ “Dangers of Commodity Indexes,” Aug 5, 2009 - http://stopgamblingonhunger.com/?page_id=435

AIG-funded study in 2004⁷ suggested that, “commodity futures returns are negatively correlated with equity returns and bond returns,” more recent returns show this not to be true. As market analyst Adam White explained, “Now it turns out that once investors flocked into commodity indices that two things happened: (1) They flipped the markets into a state of persistent contango so that instead of the roll yield providing a 4-5% lift to returns (making them equity-like) it is instead causing an 11-12% drag on returns (making them terrible) and (2) The correlation between the S&P 500 and the S&P-GSCI index has risen to as high as 80% so that they provide no diversification benefit whatsoever... Anybody that invested in the S&P-GSCI TR Index from 2004-2008 is losing money as of today.”⁸

For all these reasons, we respectfully ask you to not invest any part of the CALSTRS portfolio in commodities. We would like to discuss this topic further with you and at your earliest convenience. If you are interested in such a meeting or to respond to this letter, please write to David Kane at dkane@maryknoll.org.

Sincerely,

ActionAid USA
Agricultural Missions Inc.
Bartimaeus Cooperative Ministries
California Black Farmers and Agriculturalists Association
Center for the Advancement of the Steady State Economy
Center for International Policy, Americas Program
Columban Center for Advocacy and Outreach
Consumer Watchdog
Environmental Partnerships
Food First
Friends of the Earth US
Gasoline & Automotive Service Dealers of America
Grassroots International
Institute for Policy Studies, Global Economy Project
Interfaith Center on Corporate Responsibility
Maryknoll Office for Global Concerns
Maryknoll Sisters, Corporate Responsibility Office
Missionary Oblates, JPIC Ministry
Municipal Electric Systems of Oklahoma
Municipal Gas Systems of Oklahoma
National Family Farm Coalition
National Latino Farmers & Ranchers Trade Association
New England Fuel Institute
New Rules for Global Finance Coalition
Oilheat Institute of Long Island
Pax Christi USA
Pesticide Action Network North America
Sisters of Charity of Saint Elizabeth, Corporate Responsibility Office
Sisters of the Holy Cross - Congregation Justice Committee

Sisters of St. Dominic of Caldwell, NJ
Sisters of St. Francis of Philadelphia, CSR Office
Sisters of the Good Shepherd
The Affording Hope Project
Tri-State Coalition for Responsible Investment
Vermont Fuel Dealers Association
WhyHunger
World Development Movement

⁷ Facts and Fantasies about Commodity Futures, Gary Gorton and K. Geert Rouwenhorst, June 14, 2004
<http://www.usafutures.com/facts.pdf>

⁸ “Imagine Investing in Commodities from 2004-2008, and Losing Money,” Feb 27, 2010
<http://seekingalpha.com/article/190992-imagine-investing-in-commodities-from-2004-2008-and-losing-money>

Partial list of studies documenting the detrimental effects of excessive commodity speculation:

Universities & Think Tanks

- [R.S. Eckaus – MIT Center for Energy Environmental Policy Research \(CEEPR\)](#)
- [Amy Myers-Jaffe – James A Baker III Institute @ Rice University](#)
- [Mohsin S. Khan – Peter G. Peterson Institute of International Economics](#)
- [Randall Wray – Levy Economics Institute](#)
- [Nouriel Roubini – NYU](#), and [HERE](#), and [HERE](#)
- [Jeffrey Sachs – Columbia \(formerly Harvard\)](#)
- [Robert Shiller – Yale – Author of “Irrational Exuberance”](#)
- [Paul Krugman – Princeton & LSE – Nobel Prize winner](#)
- [Robert Aliber – University of Chicago – Co-Author “Manias, Panics & Crashes”](#)

Wall Street Analysts

- [Tim Evans – Citigroup – Energy Analyst](#), and [HERE](#)
- [Adam Sieminski – Deutsche Bank – Chief Energy Economist](#)
- [Ed Morse – Lehman Brothers \(now LCM Commodities\) – Chief Energy Economist](#)
- [Eugen Weinberg - Commerzbank – Oil Analyst](#)
- [Ahmad Abdallah - GaveKal – Energy Analyst](#)
- [Fadel Gheit – Oppenheimer – Energy Analyst](#)
- [John Kemp formerly oil analyst with RBS Sempra](#)
- [Don Newell – Probalytics – Quant Research Director](#)

Regulators & Governmental Agencies

- [U.S. Senate Permanent Subcommittee on Investigations](#)
- [International Monetary Fund](#)
- [International Energy Agency](#)
- [United Nations Conference On Trade And Development](#), and [HERE](#)
- [OPEC](#), and [HERE](#), and [HERE](#), and [HERE](#)
- [G8 Finance Ministers](#)
- [Federal Energy Regulatory Commission](#)
- [U.S. Secretary of Energy – Steven Chu](#)
- [Japanese Ministry of Economy, Trade & Industry](#)
- [CFTC Chairman – Gary Gensler](#)
- [CFTC Commissioner – Bart Chilton](#)