

# Get off the Commodity Rollercoaster

## Procurement organizations must take a more strategic approach to managing commodity price intelligence

By Editorial Staff

Commodity prices have been on a rollercoaster ride over the past five years. The run-up in prices during the most-recent “super cycle” peaked in mid-2008, according to various indices. The widely watched IHS Global Insight Industrial Materials Price Index (GIIMPI), for example, reached a high-water mark in July 2008 before precipitously plummeting through the end of that year, giving up most of the gains accumulated over the previous six years. (See **Figure 1.**) But 2009 saw commodity prices claw their way upward again, and continued gains in 2010 put margins at risk for many companies as weak consumer confidence made it unpalatable to pass cost increases on to end customers. Copper, for example, traded at highs around \$9,000/tonne in early 2008, but crashed to a low just under \$3,000 by the beginning of 2009 – only to recover to over \$8,500 by October 2010.

This commodity price volatility is not a surprise to John Mothersole, a principal in the Industry Practices Group at IHS Global Insight, the economic and financial information and forecasting business of IHS, Inc. Mothersole, a nonferrous metals analyst and a 30-year forecasting veteran with IHS Global Insight, points to the increased instability in raw material prices since 2000. “If you look back at specific time periods over the last 20 years across any number of

commodities or sectors, what is striking is that the volatility has increased as you move forward in time,” says Mothersole. Economists looking to explain the surge in volatility point to factors as diverse as the increasing demand for goods among rapidly growing middle-class populations in emerging nations like Brazil, China and India, the impact of extreme weather, or the growing influence of investors.

This persistent rise in volatility has served as a symptom of the increased risk environment of the “New Normal” economy and has certainly captured the attention of supply chain executives: AMR Research, now part of Gartner, has documented in its quarterly supply chain risk surveys that supply management executives viewed commodity price volatility as a “top three” risk in their supply chain. In response, procurement departments have started to employ strategies like hedging or crafting long-term contracts with price adjustment clauses. However, Mothersole suggests that companies also could benefit from putting in place a process for effectively and strategically leveraging commodity price intelligence.

### The Long View of Prices

The key to understanding commodity prices, Mothersole says, is recognizing the tremendous amount of information contained within prices, including the costs underlying the production of a



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given commodity and the supply and demand dynamics that are driving changes in the price of that commodity. “You need to have a long enough historic perspective so that you can place current events in their proper context and gain an understanding of what is driving price changes,” explains Mothersole, whose background is in economics. This more sophisticated perspective on price drivers, in turn, serves as the basis for understanding where prices are heading in the future and the foundation for more advanced risk management strategies like hedging.

The most recent commodity price super cycle offers a simple example of how this long-term perspective can benefit an organization. By 2007 and 2008, IHS Global Insight began to see price levels across virtually all commodities rising well above their long-term trend path when viewed over a 20- or 30-year time span. That led analysts like Mothersole to look at the cost drivers at work within specific industries to see whether the cost profile underlying a commodity had fundamentally changed.

“What we found in most, although not all, cases was that relative to costs, prices were elevated, and we saw very wide margins in a large number of industries,” Mothersole says. “Those

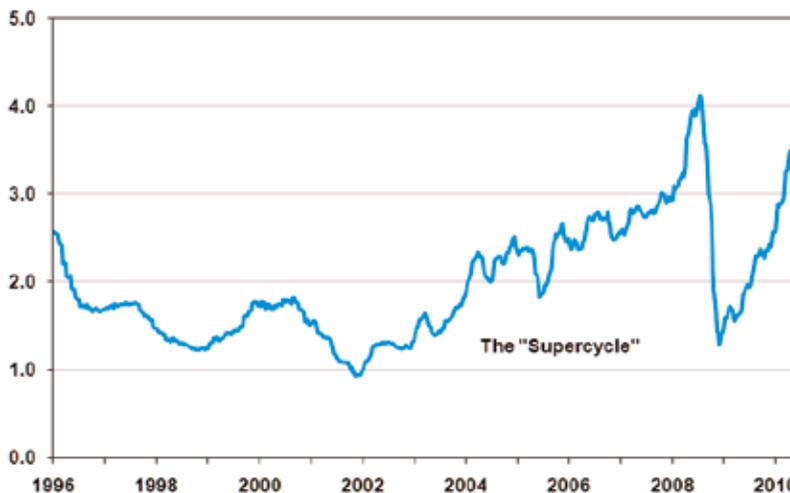
kinds of profits are usually self-ending in the sense that if markets are flexible enough to react, they will work to eliminate those kinds of excess profits.” The conclusion that the high price levels were not sustainable would lead a procurement organization to a different set of strategies (shorter-term contracts, for example) than a belief that prices were going to continue to rise unendingly (which might dictate locking in longer-term contracts).

### A Strategic Approach

Mothersole suggests that a company aggregate its spend into buckets that can be assigned to purchasing codes and given a relevant market price measure, so that the company can understand which commodities it should be tracking. With that as the foundation, the company can put in place a centralized data gathering and monitoring process, supported by the necessary data management systems, to allow them to effectively track price movements over time for the commodities that matter – or matter most – to that specific company.

Next, tap into the kinds of historical databases of pricing information that an organization like IHS Global Insight can provide, so that the company can understand the trend lines for its critical commodities. The goal initially is not to try to forecast where prices are headed but rather to monitor the marketplaces across the array of materials that the company purchases. However, once a company does gain that historical perspective, it can start looking at price forecasts for those commodities, peering quarters or years into the future and assessing the impact on the company’s cost structure based on the kind of forward-looking data that Mothersole’s Pricing and Purchasing Service offers. Procurement staff can leverage that information as the foundation for hedging and other strategies to mitigate

Figure 1. Global Insight Industrial Materials Price Index less Oil, 2002:1=1.000



the impact of price volatility. Over time, the company should be able to establish pricing benchmarks to rate their performance against their industry’s cost curve – and to peg variable compensation of procurement staff and executives to that performance.

Mothersole’s company consults with procurement organizations to help them implement and leverage the kinds of processes and systems described above, and he points to several success factors for these sorts of initiatives. “The organizations that tend to use the information more effectively usually have a central authority within the organization that is responsible not necessarily for collecting the information but for analyzing it,” he advises. It often falls to individual buyers or purchasing managers to maintain an information structure or flow related to their specific area of expertise, but it’s critical that the information not remain siloed. Rather, the buyer or manager should be responsible for pushing the information up to that larger, central analytical organization – a sort of “central intelligence agency” within the supply management function that can look more broadly or strategically across the company’s spend. These analysts often come from diverse

functional backgrounds, whether from manufacturing, finance or engineering. Moreover, they typically will work cross-functionally, establishing lines of communication with engineering, for example, to understand the company’s engineering requirements and how those will shape its supply needs.

Perhaps most important, Mothersole says that procurement staff must build a competency in seeing the forest for the trees. Incorporate a variety of sources into an analysis of commodity prices, ranging from the type of historical and forward-looking data that a company like IHS Global Insight offers; to government sources of information like US Department of Commerce and US Geological Survey, or the Australian Bureau of Agricultural and Resource Economics (ABARE); to mainstream media like *The Economist*, *The Wall Street Journal* or *The Financial Times*; to new media blogs and other Web sites. “It’s valuable to collect as many pieces of the puzzle as you can, so that you can put together a mosaic, and the more puzzle pieces you have, the more complete the picture,” Mothersole says. “But what’s critical is being able to see that whole picture from the individual pieces.” ■