

Commodity Investing in Today's Volatile Environment

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Recently, commodity investing has not been for the faint of heart. Plunging oil, gas and gold prices, softening world demand and the lack of inflation have driven this asset class out of favor. However, commodities can play a valuable role in a well-diversified portfolio. The traditional appeal of commodities is their lack of correlation with other major assets classes such as stocks and bonds. When stocks or bonds fall, commodities often remain stable or move in the opposite direction. In addition, commodities have offered inflation protection as their prices tend to rise along with inflation.

It may be a good time to revisit commodities due to their recent poor performance. Many global commodities are down while most other indices – including both stocks and bonds – are at all-time highs. Oil is down over 35% as we approach the end of the year due to softening worldwide demand and excess global production. Gold is hovering at 2014 lows and off 40% from its record 2011 high of \$1900 an ounce. Grains continue to suffer, as farmers planted unusually large crops based on the recent period of high prices, and good weather further boosted yields. Given the under-performance across many commodity classes, perhaps it is time for another look.

Why commodities? - Commodities are the raw materials and basic goods used in production and commerce. They are the building blocks for both developed and emerging economies and are needed to fuel progress and growth. Some examples include oil, gold, silver, copper, platinum, wheat, corn, cattle coffee and soybeans. However, cyclical and seasonal factors influence commodities' prices, making them very volatile. Examples are supply/demand, weather, floods, drought, acts of God and terrorism. As such, the allocation to your portfolio should be small, at about 5%. Commodities are best suited for larger portfolios that benefit from size and scale.

Downside - In addition to the volatility issues discussed, commodities don't produce income or give investors a stake in the future profit of a business like stocks and bonds do. Long-term returns on commodities have been mixed based on each individual component. Investors should allocate to the sector based on diversification and inflation protection and not bet on blockbuster returns.

Ways to invest-

Physical Purchase – While this is not the practical way to do things for most individuals, it is possible to buy the physical commodities. Storage costs and security concerns are key. It is

easier to put some gold bars in your safe deposit box than to store a barrel of oil. An example of such a product is the SPDR Gold Trust Exchange Traded Fund (ETF), the biggest physically backed gold ETF in the world.

Futures – A futures contract is a standardized agreement to buy or sell a commodity at a specific date in the future at an agreed upon price today. These contracts tend to involve leverage, as a small amount of cash can control a large amount of commodity. The contracts also need to be settled, requiring a futures fund to roll these positions. This method should only be used by experienced and sophisticated investors.

ETNs/ETFs (exchange traded notes and funds) – This is a less risky way to track the price of a specific or basket of commodities. The ETN is a debt security issued by an underwriting bank. The ETF is a low-cost fund with stock-like features. Many ETFs invest in futures contracts rather than exposure to the commodities spot price. ETFs tend to eliminate company specific risk.

Buy companies that produce a certain commodity - Our preference is to not buy the outright commodity but instead buy the stocks of companies involved in the production/extraction of the product. This type of investment provides a form of leverage on volatile prices. As an example, when the price of the underlying commodity rises, profits for the miner or oil producer often increase as the majority of the costs of extracting the product are fixed. When prices fall, the companies can often cut back production and reap income from other business lines. In addition, while commodities themselves do not pay interest or dividends, investments in these stocks often do, and provide a bit of stability to underlying earnings volatility. So if you want oil exposure, invest in **Exxon Mobil (XOM)** or **Chevron (CVX)**. If interested in gold, try **Barrick (ABX)** or **Newmont Mining (NEM)**.

Where in cycle now? – Earlier in 2014 commodity prices slid as concerns about weak worldwide economies and a slowdown in China tempered demand for commodities. Current plunging oil prices are the result of overproduction from both U.S. and Middle Eastern sources, with no party being willing to cut back production to stabilize prices. This has increased deflation fears. Easier U.S. monetary policy has led to a stronger economy and job growth, with investor sentiment now leaning towards the belief the Fed will raise rates sooner rather than later. Higher rates usually benefit the U.S. dollar as investors flock to buy our debt. However, a strong dollar is often detrimental to commodities' prices, which are reflected in dollars and thus more expensive for foreign investors. In addition, the strong U.S. stock market has siphoned investment dollars away from gold. These confusing and conflicting scenarios drive home the point that commodity prices are influenced by many factors and are notoriously difficult to predict!

Conclusion: Commodities offer a source of diversification due to their historic lack of correlation to the stock and bond asset classes. In addition, they can be a good inflation hedge as prices often tend to rise during periods of inflation when currencies lose value and investors seek to preserve purchasing power. We recommend limiting exposure to 5% of your portfolio and make exposure broad-based. Often commodity classes move in opposite directions, indicating the need to have wide exposure to both hard and soft commodities. Diversify amongst energy, agriculture, and precious metals. Consider acquiring your exposure through the purchase of stocks in

commodity producing companies in order to mitigate some of the price risk and provide a dividend income stream to stabilize volatility.