

Vehicles for Investing: Commodities or Commodity Companies?

By John Stephenson

Article Highlights

- Commodities account for a sizeable portion of global trade and provide a hedge against inflation.
- Commodity futures need to be rolled forward, unless an investor wants to take physical delivery.
- Commodity-producing companies provide leverage to rising commodity prices.

The global economic order is rapidly changing—creating tremendous opportunities for commodity investors.

Demand for commodities continues to grow despite the fact that much of the world is still licking its wounds from the global economic collapse of 2008–2009. Western governments have tried to paper over the problem of sluggish consumer demand by implementing stimulus programs intended to jump-start infrastructure spending—for example, the Cash for Clunkers rebate scheme aimed at the beleaguered American car industry. But despite these efforts, the collective credit cards of the U.S. and much of Europe remain completely maxed out.

The wheezing Western recovery aside, demand for commodities remains strong. Commodities are a big deal, much bigger than most people realize. Primary commodities, such as iron ore and copper, account for 25% of global trade. Supply has been sidelined during the global economic collapse, creating a near perfect storm for investors—a situation that is likely to last for many more years. As the basic feedstock for industrial and urban growth, commodities can be red hot even when stocks and bonds are ice cold. And



with their direct link to the drivers of inflation, commodity investments are a heaven-sent hedge against rising prices.

Despite these benefits, commodities tend to be grossly under-represented in most investment portfolios. To be a total investor is to know something about commodities—especially with a commodity bull market washing up on our shores. Yet commodities are a mystery to many investors: Most haven't a clue how to begin.

Dumb Luck

One way to get into commodities is to luck out. You could find oil on your property as happened in the 1960s television show “The Beverly Hillbillies,” or you could stumble upon a major gold discovery. You might even inherit the family farm. In any of these situations, you'd be in the commodity business, but if you haven't yet struck oil on your swampland, chances are you won't.

Even if you do get lucky, you'll need plenty of help developing your find before you can pull up stakes and move to Beverly Hills. However, while it may look simple on TV, capitalizing on a producing commodity business is anything but easy. It is a highly sophisticated and complex undertaking requiring millions of dollars and decades of experience—not to mention good luck and excellent judgment. Owning a farm, mine, or oil field just isn't a practical way to add commodities to your investment lineup.

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Hot Commodities

- Owning your own oil field, mine, or farm is one way to get direct physical exposure to commodities, but it just isn't practical for most people.
- The price of a given futures contract will always converge to the "spot price," or cash market price at expiration, but a lot can happen between the dates when futures contracts begin and expire.
- During the 1980s and 1990s, the futures curve for most commodities was downward sloping (backward-ation), yet commodity funds were posting excellent results since they were able to buy low and sell high.
- Most stock indexes are constructed and weighted according to the market capitalization of their components. In commodities, however, the concept of market capitalization doesn't apply.
- Commodity indexes are often poor barometers for gauging activity levels in commodities.
- Commodity-producing companies offer leverage to rising commodity prices and the opportunity to benefit from reserve additions over time.

Go Along to Get Along

Investors love index funds and exchange-traded funds (ETFs) because they mimic the price movements of their underlying indexes and give investors an inexpensive and transparent way to get direct commodity exposure. There are several major indexes and plenty of exchange-traded funds to choose from.

The granddaddy of all commodity indexes is the Reuters/Jefferies CRB Index, which dates back to 1957. The index has gone through 10 revisions over the years to help keep it both relevant and reflective of the underlying economic demand for the various commodities it represents. Most recently, in 1995, natural gas was added to the index while lumber, pork bellies, unleaded gasoline, soybean oil, and soybean meal were dropped.

In 1992, investment bank Goldman Sachs created a commodity index known today as the S&P GSCI. Another big player in the commodity index game is UBS, which has two widely followed indexes: the Dow Jones-UBS Commodity Index and the UBS Bloomberg Constant Maturity Commodity Index (UBS Bloomberg CMCI), created in 1997. Jim Rogers, the Wall Street investment legend, created his own index in 1998, called the Rogers International Commodity Index (RICI).

A problem for all commodity indexes is how to weight their various components to provide a true reflection

of their overall economic importance. Most stock indexes are constructed and weighted according to the market capitalization of their components. In commodities, however, the concept of market capitalization (number of shares outstanding multiplied by stock price) just doesn't apply. Commodities are held in a variety of forms, including over-the-counter investments, offsetting futures positions, and physical producer stockpiles—the combination of which makes complete accounting impossible and the calculation of commodity market capitalization an elusive target.

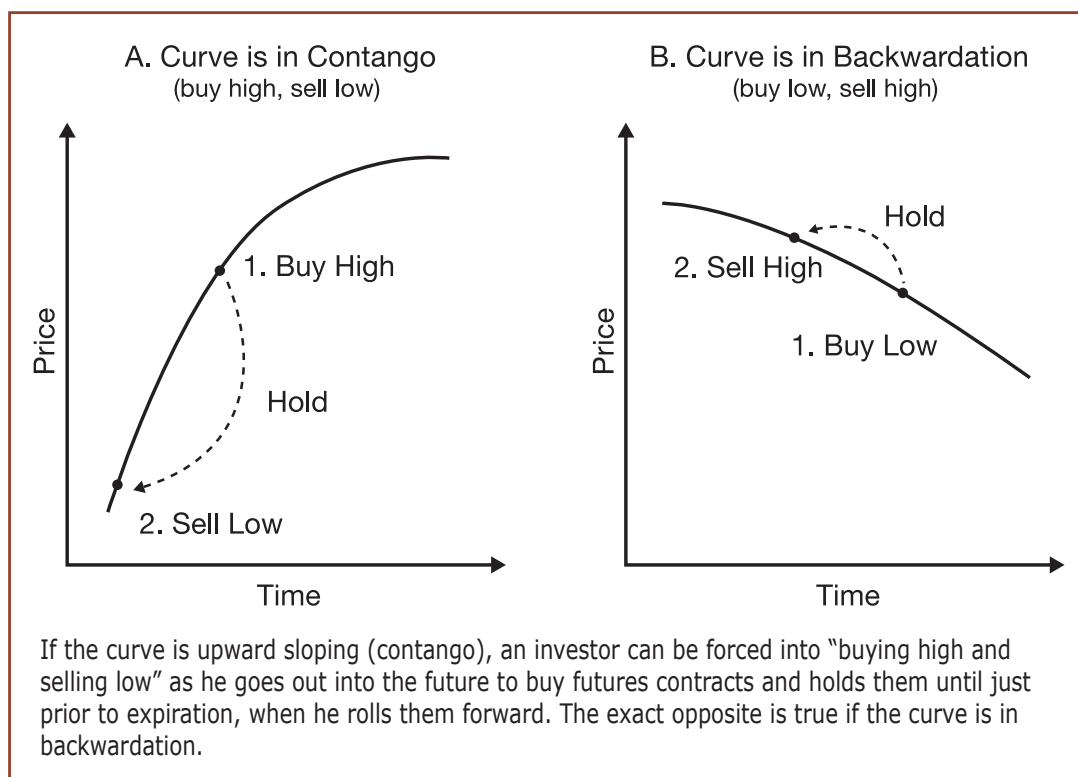
Without the availability of market capitalization figures, commodity index creators have been left to their own devices, constructing and weighting the various components as they see fit. The result is a wide range of methodologies that can dramatically skew the weights of the index and its relevance as a barometer for gauging activity levels in commodities. Some base their weights on an assessment of the economic importance of each commodity, while others base them on a quantity of production basis. Subjectivity often plays a major role in this process—oil being a case in point. As the most economically important and actively traded commodity, oil's importance to the global economy cannot be overstated. In November 2009, the target weights for energy in the S&P GSCI were a whopping 67.83%, yet the Reuters/Jefferies CRB Index set its energy target weight

at just 18%—a difference of nearly 50 percentage points.

Investors buy index funds and index-linked ETFs under the assumption that they will mimic the price appreciation they expect for the underlying commodities. Unfortunately, they are often disappointed. Not only do all commodity indexes struggle to find an appropriate weighting of components, but most also do a poor job of measuring the here-and-now price movements of commodities. An investor who sees that oil prices are up \$2 per barrel may justifiably assume that his or her commodity index fund is flying high; and if that investor is lucky, it will be. What all commodity index funds do is buy a basket of futures contracts, usually near-month contracts, which *should* closely track the price in the here and now (also known as the "spot price") movement of the various commodities. Unfortunately, they often don't. During the first 11 months of 2009, for instance, the price of crude oil surged some 73%, yet the S&P GSCI, with its heavy target weighting to oil, was a laggard—increasing just 46.88%.

Ready to Rock 'n' Roll?

You can make a lot of money in futures trading if you know what you're doing. And if you don't—well, let's just say you can lose your shirt in a hurry. Commodity futures are just that: Contracts for the future delivery of a given

Figure 1. Commodity Futures Curve

commodity. While commodity futures prices often resemble what's happening in the here and now, or the "spot market," this isn't always the case. Complicating matters further is the fact that most futures contracts trade monthly and need to be rolled forward—unless you want to take physical delivery of the commodity you just bought. And discovering you're the proud owner of a thousand barrels of No. 2 heating oil, currently waiting for you at New York Harbor, can sure throw a wrench in your weekend plans.

Depending on investors' expectations of commodity prices, the futures curve can either be upward sloping (contango) or downward sloping (backwardation), as shown in Figure 1. The futures curve is nothing more than a compilation of individual futures contracts, so if investors expect oil prices to be going higher over time, then you should expect an upward sloping (contango) futures curve. If, many months into the future, the price of a commodity is significantly higher than it is today (contango), it may pay to hoard the

physical commodity in the hope that you can sell it later for a profit. Oil traders and companies did just that during the 1970s when they hired tankers to store crude oil for months until they could sell it at a profit.

In commodity investing, the devil really is in the details, and the shape of the commodity curve is no exception. We've always heard that successful investing is all about buying low and selling high, but if you're buying futures contracts when the commodity curve is in contango, you're doing just the opposite. During the 1980s and 1990s, the futures curves for most commodities were downward sloping (in backwardation), yet commodity funds were posting excellent results since they were able to buy low and sell high.

Managing the Future

Between 2002 and early 2008, commodities were back in vogue after a 20-year hiatus, and commodity trading advisors (CTAs) were suddenly in demand, moving their products faster

than free ice cream on the Fourth of July. The idea behind managed commodity futures is simple. A commodity trading advisor manages a pool of investments, taking care of the pesky details like contract rolling, and giving you exposure to a wide range of products. Rather than studying the supply and demand variables for the soybean market for the wee hours of the morning, you hire an expert to make decisions for you.

Of course, managing futures contracts doesn't come cheap. There are tremendous benefits to obtaining professional management, but while some CTAs are proven mon-

eymakers, many aren't—which means that your returns are going to be only as good as your advisor's expertise. Regardless of whom you choose, it's important to know that you're giving up both investment control and transparency when you use a CTA. If your CTA decides to move aggressively into frozen orange juice futures because he's spending winters in Florida, for example, you may find that your once well-diversified portfolio is now juiced-up on just a few commodities.

Company Man

So what's a commodity investor to do? Commodity indexes and ETFs are easy to buy, but as I've explained, most have serious issues with weighting and tracking. If getting direct exposure to commodities by snapping up farmland in Ohio or panning for gold in Nevada seems like too much work, you should consider buying the stocks of commodity-producing companies. A key benefit of owning these is the lever-

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These plans allow shareholders to use their dividends to purchase additional shares of stock, instead of receiving dividends in cash. (The dividend is still taxable, even if it is reinvested, for shares held in a non-retirement account.)

There are typically little or no transaction costs, though you should check with the company to be sure.

Conclusion

This High Relative Dividend Yield

screen identifies companies with strong dividend credentials that are trading at relatively high yields. Though dividends can add to total return, they do not protect a stock from the market's volatility.

Keep in mind that stock screens such as this high-yield approach only represent a starting point in the investing process. They allow you to isolate companies with similar quantifiable characteristics. However, it is important to perform additional due diligence

on any company that passes a stock screen. The end goal is to find stocks that match your investing timeframe, tolerances and constraints.

Finally, pay attention to any tax legislation this year. If Congress does not act, dividend tax rates will rise in 2011. This will adversely impact aftertax returns and could potentially influence sentiment toward high-yield stocks. If Congress does act, it is unclear what the tax rate on dividends will be and how it might affect investing decisions. ▲

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Feature: Commodities

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age you get to rising commodity prices. As long as the gain in the price of the commodity that the company produces outstrips any increase in their costs, you're laughing. When buying stock, you're also making an indirect bet on management—so nail the commodity and the management call, and you're sitting pretty. Best yet, many commodity producers are routinely able to build their reserves over time as they uncover

more resources on the lands they lease. Buying commodity-producing equities allows you to prosper not only in the here and now as commodity prices improve, but also in the future as rising prices allow additional reserves to be discovered. Chosen prudently, commodity-producing equities can be a gift that keeps on giving.

In my career I've tried it all, and I keep coming back to a well-chosen

basket of commodity-producing companies. With futures there's the "roll risk" to manage, plus a wide variety of new markets to study up on. Most commodity index funds are far too dependent on the shape of the curve to give you the kind of exposure you're looking for. For my money, the choice is clear: Commodity producers are the way for most investors to profit from a roaring commodity bull market. ▲

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