Title:
Do Commodities Belong In Your Portfolio?

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Summary:
Although it may sound frightening and risky to many investors, if handled correctly, commodities could be the missing piece of an investor’s portfolio. In short, commodities have historically been a good compliment to a traditional stock, bond and real estate portfolio.

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Article Body:

Although it may sound frightening and risky to many investors, if handled correctly, commodities could be the missing piece of an investor’s portfolio. What exactly are commodities? Commodities are any mass goods traded on an exchange or in a cash market including: cocoa, coffee, eggs, lumber, orange juice, soybeans and sugar just to name a few. Industrial metals are also included with copper, aluminum, zinc, nickel, silver, and lead ranking among the most popular industrial metals holdings. Finally, the most widely followed commodities include oil, natural gas and gold.

The diversification benefits equal or surpass those of other asset classes like fixed income and real estate. The primary reason for this is their correlation, or lack thereof, to the stock market as represented by the S&P 500 (Correlation describes how similar the price movement is between two investments). Commodities have historically exhibited absolutely no correlation to the stock market or any of the bond market indices. In fact, they have a negative correlation. This non-similar pattern of performance allows an investor to minimize volatility and protect capital in down markets. Overall, these factors help to decrease overall risk in a portfolio of investments. In short, commodities have historically been a good compliment to a traditional stock, bond and real estate portfolio.

When commodities are utilized as a stand-alone investment, commodities are relatively volatile, exhibiting wild price swings. At times, they are also illiquid, prohibiting the investor from exiting a position that is dropping rapidly. Another factor to be aware of when investing in commodities is the unusual income taxation. Most notably, investors are taxed each year on their share of the profits, if there are profits, regardless of whether the investment has been sold. This is a significant disadvantage compared to investments in stocks, because one does not pay income taxes until the stock is actually sold. Finally, fees to implement a commodities strategy are significantly higher than for those of traditional mutual funds, for example. For these reasons, it is best to only consider 5-20% of one's portfolio for this strategy.

At a time when stocks and bonds are predicted by most academics and investment gurus such as Warren Buffet, Bill Gross of PIMCO, and Jeremy Grantham of Grantham, Mayer, and Van Otterloo, to produce 5.0% returns or less over the next decade due to historically high market valuations. On a historical basis, commodities are inexpensively priced and substantial upside potential is possible. U.S. inflation is historically low right now but with the effects of massive fiscal, monetary policy and already robust consumer spending, raw goods prices will inevitably increase. When they do, commodity indices will follow. As inflation gradually rises in 2006 and beyond, industrial metals prices will rise as investors begin to direct large amounts of money into these hard asset commodities. The high correlation between commodities and inflation provide an important hedge against considerable losses in traditional financial instruments such as stocks and bonds.

In his recent book "Hot Commodities", author and renowned investor Jim Rogers summed it up this way:

The 1980's and 1990's saw a bear market in commodities. Prices had fallen to levels (adjusted for inflation) not seen since the Great Depression.

For 130 years, stocks and commodities have alternated leadership in regular cycles averaging 18 years.

The long bear market in commodities has created a sharp reduction in capacity – and thus large supply-and-demand imbalances.

As economies in Asia continue to grow, there will be a strong worldwide demand for all commodities.

Historically, the prices of commodities show a negative correlation to the prices moves of stocks, bonds and other financial instruments.

Commodity prices can rise even when the economy is stuck in reverse and their returns outpace inflation.

The U.S. Federal Reserve and other banks in the world have been pursuing a policy of debasing their paper currencies.

The U.S. Federal Reserve’s policy of monetary stimulus and rapid credit expansion will continue to push up the prices of hard assets such as precious metals and other commodities.

History shows that war and political chaos only push commodities prices higher.

Commodities also provide a tactical play on the current weakness in the U.S. Dollar. As other currencies such as the Euro and Yen appreciate versus the dollar, foreign buyers can buy less goods with the same amount of currency. This artificially increases demand, and subsequently drives up the prices of commodities. Currently, effects of this phenomenon can be seen best in the gold and silver markets as prices have risen dramatically over the past year.

Commodities provide a play on globalization by their ability to aid in the improvement of the global economy. This is due to the fact that prices for industrial materials will increase as demand for industrial goods increase. As countries such as China and other emerging market economies develop, they will require more raw materials. This is especially true for industrial metals. China continues to develop at a rapid pace and consequently, their demand for raw materials continues to rise. In fact, China’s iron ore demand has increased from 5% of the world’s supply to almost 50% over the past twelve years.

Commodities have proven to be excellent investments over the last few years. There are a number of types of investment vehicles to take advantage of this great diversification play. Many of our client portfolios have benefited from this recent performance. With only small allocations to hard assets, most client portfolios have delivered returns that were twice the performance of traditional stock and bond portfolios.

Many experts agree that U.S. stocks and bonds will, in all likelihood, generate significantly lower returns over the next decade. Commodities on the other hand may have the potential for the highest returns since the 1970s due to a worldwide economic expansion especially from emerging market countries.