

SHOULD YOU CONSIDER INVESTING IN COMMODITIES?

Are you concerned that bonds have run their course as interest rates start to climb, and that the returns for stocks in the coming decade may be below their historical average, as some observers predict? How about adding a little pork belly to your investment portfolio? Or soybeans, copper, gold, timber, cattle futures, or oil?

Commodities are hot right now: The growing U.S. and world economies, and especially the booming economy of China, are driving up commodity prices, and investors are buying them for speculative gains and as a hedge against potential inflation. The Dow Jones-AIG Commodity Futures Index, for example, was up 24 percent in 2002 and again in 2003 (in part due to a declining dollar), though it was up only about 5 percent through early July 2004.

But investing in commodities because they're "hot" is the wrong reason to buy them, caution financial planners. The compelling reason to consider commodities is the long-term diversification role they can play in portfolios, even modest ones. But before buying commodities, it's important to understand them as investments, how they fit into portfolios, and how you might invest in them.

Commodities are essentially the raw materials societies' use: agricultural products such as wheat, cattle, and coffee; energy products such as oil and gas; and natural resources such as timber, silver, and the most glittering commodity of all, gold. These tangible investments are in contrast to what's been the predominant investment of the last 20 to 30 years – intangible financial investments such as stocks and bonds.

Commodities tend to do well during inflationary times, while stocks and bonds tend to abhor inflation. The fact that commodities typically perform differently than stocks and bonds is the major reason many investment experts like them in portfolios.

Studies have shown that the addition of commodities can reduce volatility and increase returns. For example, a study that appeared several years ago in the *Journal of Financial Planning* examined the benefits of mixing multiple asset classes in a portfolio. The four assets it studied were domestic large-cap stocks, international stocks, real estate investment trusts, and commodities. The study looked at the four asset classes alone and in equally-weighted combinations of two, three, or all four classes.

During the period studied, from 1972 to 1997, commodities by themselves had the lowest average returns and the highest volatility of the four assets. Yet of the top five portfolio combinations showing the best performance and the lowest volatility, commodities were included in every single one of them. The study noted specifically that the commodities performed counter-cyclically to the other asset classes, thus reducing the “downside risk” when the other assets faltered during bear markets.

If you do include commodities in your portfolio, the general recommendation is to keep it small – around five to ten percent of the portfolio’s total value.

The easiest and generally the best way for most investors – particularly those with modest portfolios – is to invest through commodities-based mutual funds. Some are broad-based funds that track major commodities indexes; others concentrate on specific sectors such as energy or other natural resources. The advantage here is that you don’t have to invest a lot to add commodities to your portfolio, and you have professional management working for you in a very challenging investment arena. But before buying, see what exposure to commodities your current mutual funds might already have, so you don’t overexpose this sector.

A second way is to buy individual shares of commodity companies, such as gold mining firms, oil companies, or forest product businesses. Or you can buy commodities directly, primarily precious metals such as gold or silver. But here you usually face steep transaction and storage costs, and have less liquidity. And with individual stocks and precious metals, you can’t diversify your portfolio as efficiently as a mutual fund basket of commodities can.

The last option is buying commodity futures, generally considered the riskiest way to invest in commodities. Here you buy the rights to a shipment of something such as wheat or hogs for a particular price at a particular “settlement” time. Profits or losses are based on price changes leading up to the settlement (most investors sell their contracts before actually receiving the shipment). And because futures are commonly bought with borrowed money, it’s easy to quickly lose a lot of money should you guess wrong.

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