Considering Commodities: Benefits and Traps

by Amy E. Buttell

Commodities investing, once an obscure corner of the markets, has moved into the mainstream thanks to mutual funds, exchange-traded funds, and other vehicles that easily allow investors to partake in a wide spectrum of investing opportunities from oil and gold to wheat and soybeans. Although including exposure to commodities can potentially benefit client portfolios, it can also hold many traps for the unwary.

"We've seen increasing interest from the financial community, including financial advisers, in commodities," says Wayne Lin, portfolio manager and investment strategy analyst at the Legg Mason Strategic Real Return Fund. "Many advisers are looking at commodities due to the resource scarcity story that has been in play recently, and commodities can serve as a good hedge against that."

The Case for Commodities

For Adrian Cronje, chief investment officer at Balentine, an investment management firm in Atlanta, one reason to incorporate commodities into client portfolios is to protect against unanticipated inflation. "Commodities always tend to contribute to portfolio performance when inflation is higher than expected, and it's unanticipated inflation that really matters," he says.

Commodities are particularly effective in hedging against inflation that isn't typical inflation generated by increases in consumer prices, he adds. "The type of inflation we're experiencing today is not the garden-variety, consumer-basket type of inflation," says Cronje. "It's the debasement of fiat currencies, what is referred to as financial repression. It's the dollar and other currencies depreciating against hard assets. This is due to the serious questions over confidence of the fiat money system, and more people are regarding gold and precious metals as a sort of currency versus a pure commodity."

Lin agrees. "To me, the driving reason behind investing in commodities is because you're worried about some type of inflation, whether that is monetary inflation or scarce supply inflation," he says. "Commodities work well in both these situations. In monetary inflation, the dollar craters, so if you are holding oil or gold, those will shoot through the roof. And if there's inflation due to scarce supply, commodities will go up, too."

On the macro-economic side, a compelling story line for commodities has been the scarcity of resources in a world hungry for them, especially in regard to emerging-market country growth, according to Cronje. "Commodities stand to benefit in the future from stronger international economies as the developing world continues to industrialize and power global economic growth," he says.

Another consideration is the low correlation commodities have with other asset classes. "If you use a diversified commodities fund, the correlation benefit from the exposure to those commodities creates a better risk-adjusted portfolio," says Gina Beall, senior investment research analyst with Savant Capital Management in Rockford, Illinois. "Looking historically at commodities as a group relative to the S&P 500, it's very low, as it is related to other equity components. It's basically zero or negatively correlated to bonds as well."

The Case Against Commodities

If equities can seem volatile, they've got nothing on commodities.

"A couple of months ago, there was that release of oil from the Strategic Petroleum Reserve and we were down 6 percent on oil prices in one day," says Lin. "Usually, that's pretty tough for a retail investor to stomach."

Although commodities do typically show an inverse correlation with other asset classes, that doesn't hold up in extreme situations, according to David Twibell, president of Custom Portfolio Group in Colorado Springs, Colorado. "During the financial crisis, commodities held up well at first, but as it progressed, the correlations went to one and everything got hit hard," he says.

Commodities are more difficult than other investments for financial advisers to evaluate, and also more difficult to value because, as Lin puts it, they have no baked-in risk premium. "Within what I'll call purely financial assets, what makes the capital markets go is the

Incorporating Commodities into Client Portfolios

According to FPA's 2011 *Alternative Investments* study, 35 percent of advisers use or recommend gold in client portfolios, 32 percent use/recommend oil and gas investments, and 48 percent use/recommend other commodities (not including gold or oil and gas).

Advisers seem to prefer ETFs as the best vehicle for obtaining gold exposure for clients, and prefer mutual funds for incorporating other commodities into portfolios. One-third of advisers are also using managed futures in client portfolios; just 18 percent use options, and few (2.7 percent) use over-the-counter derivatives, including swaps and forwards. Look for the exclusive online article "Options: Too Risky or Tools to Hedge Risk?" by Michael A. Cavanaugh at www.FPAnet.org/Journal/CurrentIssue/Supplements.

Here's a look at how advisers are building commodities exposure into portfolios:

Commodities (not including gold or oil/gas)	
Options	**Percent**
Directly	8.2%
In a mutual fund	67.9%
In an ETF	55.1%
Other	6.1%
Gold	
Options	**Percent**
Directly	13.4%
In a mutual fund	37.3%
In an ETF	74.7%
Other	3.5%
Oil/Gas	
Options	**Percent**
Directly	42.0%
In a mutual fund	39.7%
In an ETF	39.7%
Other	12.2%

Source: FPA's 2011 *Alternative Investments* study conducted May 16–31, 2011, with 410 financial advisers who use/recommend investments for at least some of their clients. Survey respondents were able to select more than one option.

understanding that over the long term, the more volatile your asset or your return patterns are, the higher your risk premium should be," says Lin.

Another potential issue with commodities is the fact that as more products are introduced into the market, the potential for advisers to get into the wrong product increases, says John Thompson Jr., vice president and portfolio manager at Ibbotson Associates, a Morningstar company based in Chicago, Illinois. Because it's difficult to invest directly in commodities, most products are based on futures contracts or other derivatives, which can perform differently than the underlying commodity.

"Some of this risk is removed if you invest in commodities via ETNs, which use swaps, but that increases the issuer-specific risk," says Thompson. "In this area, to get around one risk you typically have to take on another type of risk."

Strategic Uses of Commodities

Commodities are not a buy-and-hold investment. Although it was reasonable a few years ago to buy a broad basket of commodities that would provide protection against inflation and depreciation of the dollar, the environment has changed, necessitating a more tactical allocation strategy.

"Commodities have become riskier in the short and medium term due to several factors, including the growing riskiness of the geopolitical environment, global interest rates and the declining values of developed world currencies, and the slowing pace of growth in China and other emerging markets due to rising interest rates," says Cronje.

As a result, it's important to fine-tune your exposure to commodities depending on the market and macroeconomic environment. Balentine, for example, recently reduced its exposure to commodities, but is still invested in gold, gold-mining stocks, and emerging market debt.

Twibell adjusts the amount of commodities exposure in client portfolios depending on the age of the client. Older clients who need more inflation protection receive higher allocations to commodities.

"We view inflation as one of the biggest potential problems for our retired clients, and commodities are one way to hedge against inflation," says Twibell. "The exact percentage depends on the individual client, but we don't go above 10 percent, and rebalance as necessary."

At Savant, commodities exposure

in client portfolios is usually between 3 percent and 5 percent, says Beall. Savant periodically adjusts the percentage allocated to commodities in client portfolios based on their expected returns and those of other asset classes. Historically, commodities have returned about 10 percent on an annualized basis. Returns come from three components: the spot price returns on commodities, the roll returns from futures, and the collateral returns from short-term fixed-income investments.

Lin notes that food and energy constitute roughly 20 percent of the Consumer Price Index (CPI), so that a reasonable portfolio allocation could be as high as 20 percent, but no higher. "Advisers really need to figure out what the right tool is for their clients and how much of it they should be using," he says.

When selecting specific products for client portfolios, give some weight to how long a specific ETN, ETF, mutual fund, or other investment has been in existence and its demonstrated track record versus its benchmark index, recommends Thompson. "Some funds are very overweighted toward energy and oil, while others are more balanced," he says. "You have to understand what you're getting into before you invest."

Cronje notes that because commodities are a very heterogeneous asset class, implementation in client portfolios can be difficult given the proliferation of other investment vehicles. "Investors don't often realize that a lot of the commodities that are going to become increasingly scarce over time aren't necessarily traded on an exchange," says Cronje. "Getting exposure through an index would not necessarily always get you exposure to things like water, iron, or a few other commodities that are going to become scarce over time. There are actively managed funds that do have exposure to these types of natural resources."

Amy E. Buttell is a freelance writer and editor in Erie, Pennsylvania. Visit her online at www.lakeeffectcreative.com.

Dodd-Frank Gives You

2,319

Reasons to Worry.

Laserfiche Makes Compliance

100%

Easier.

The Dodd-Frank Act's 2,319 pages contain at least 350 new regulations, but with Laserfiche enterprise content management, compliance is less complex. You prepare for audits more easily, improve profitability and limit liability—all while accelerating business processes and making staff more efficient.

- Meet us **September 15-17** at **FPA Experience 2011, booth #807** to find out how Laserfiche can help you prepare for the coming compliance tsunami.
- Visit **laserfiche.com/doddfrank** to get your copy of "What Financial Advisors Need to Know about the Dodd-Frank Act."
- Call **(800) 985-8533** to speak with a solutions specialist now.

Run Smarter®

Laserfiche®

© 2011 Laserfiche. Laserfiche is a registered trademark of Compulink Management Center, Inc. All rights reserved.