GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

How And When to Invest In Commodities

SYNOPSIS

- Commodities are often included in portfolios as a way to diversify and protect against rising inflation.
- Most commodities have been decimated in recent years, as China's economy slows and supplies continue to rise.
- Calling bottoms is financial suicide for most investors, but there are ways to invest safely in commodities to provide a portfolio with heightened diversification.

IT'S BEEN A BLOODBATH

Commodities seem to be crashing all around us these days. Copper, oil, and most others have been absolutely decimated from a seemingly endless list of headwinds. But seasoned investors know that commodities do two things over the long run. They go up and they go down.

Supply and demand imbalances drive the cyclical nature of commodities, and recent weak demand and ample supply have kept most commodity prices depressed for some time now.

There's no question that this trend will reverse, but the real danger to investors is determining when it will ultimately shift direction. Anytime commodity prices remain low for an extended period of time, bargain hunters emerge looking for the bottom.

These investors/traders are often more interested in bragging that they got the best price instead of thinking about their long-term financial health. They want to go tell all of their friends, "I knew I found the bottom… I could just feel it!"

Here's the thing. Calling bottoms is financial suicide for 99.9% of those in the market because there are only two possible outcomes: (1) You are going to be wrong, or (2) You are going to get lucky.

Calling bottoms is next to impossible to do on a consistent basis, so don't even bother trying.

***NOTE**: Admittedly, there are a very select few people in this world who are experts with tremendous financial strength, decades of experience, and access to superior information that allow them to gain an edge in calling bottoms. But this cohort does not read my Thought for the Week, so accept the fact that you are not one of them.*

Simply put, if you have the urge to invest in commodities inspired by this prolonged period of weakness, keep in mind that you are not capable of calling a bottom without getting lucky, and be sure that you can be patient in the event that a turnaround may take a while.

THE RIGHT AND WRONG WAY TO INVEST IN COMMODITIES

Now that we know we can't call bottoms when investing in commodities, let's discuss the right and wrong way to invest in them. There are three primary ways that individual investors can own commodities.

The first option is physical ownership of a commodity. For example, those who want to own precious metals can simply buy silver coins, raw diamonds, etc.

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Many investors prefer this method because they can actually "touch" what they own. Said another way, it feels more real.

However, keep in mind that owing the commodity typically requires storage costs, such as a safety deposit box at a bank, and insurance to mitigate the risk of theft or misplacement. Investors should also buy from reputable dealers to ensure they don't end up with fakes.

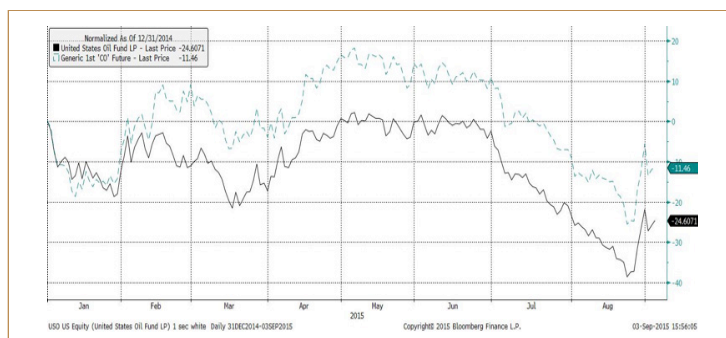
The second option is using exchange traded funds (ETF) to gain exposure to various commodities. An ETF is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. The fund owns the underlying assets and then divides ownership of those assets into shares. These shares of the ETF are then traded on stock exchanges.

For example, if an ETF was created to track oil, the fund would buy "futures contracts" for oil on commodity trading exchanges, and then issue shares to investors that gave them a claim on a portion of the value of the fund. ETF share prices would then change throughout the day in response to the prices of the oil contracts held within the fund.

NOTE: *A futures contract is an agreement to purchase a commodity at a future date at a specified price. Rather than hold physical barrels of oil in a warehouse, an ETF uses futures contracts as a simpler and cheaper method to gain exposure to the commodity.*

On paper, ETFs sound like a fantastic way to gain exposure to commodities without taking on much of the risk that exists when owning the physical commodity. ETFs also give investors access to commodities that they could never physically own, such as oil, natural gas, etc. For example, where would you store 50 barrels of oil?

However, ETFs that hold commodities are severely flawed and should never be used by individual investors. Since these ETFs use futures contracts instead of owning the actual commodity, the mechanics of these products do a very poor job of tracking prices accurately.



The chart above compares the price of oil (greenish line) to the United States Oil Fund (black line), which is a popular ETF that attempts to track the price of oil, since the beginning of the year. Although oil is currently down around 11.5%, the ETF is down more than 25.5%!

The reasons for the discrepancy are quite technical and beyond the scope of this discussion, so just remember that commodity ETFs don't work over the long run.

Lastly, investors can invest in the stocks of companies that are in commodity businesses. These stocks are highly correlated to the commodity that they mine and/or create, so they offer a liquid and inexpensive way to gain commodity exposure. Furthermore, investors can participate in a growing company over time, which should add to their overall return through capital appreciation and dividends.

Additionally, the one exception to my rule about avoiding commodity ETFs is owning an ETF that consists of these company stocks. For example, an

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ETF that owns equities of companies involved in the mining and selling of gold would be perfectly fine to own, but an ETF that simply owns futures contracts for gold should never be considered.

NOTE*: Although I do not consider gold to be an attractive investment, those who want to own gold should limit the amount to no more than 5-10% of their overall portfolio. A small allocation can offer some diversification and mitigate volatility during turbulent times.*

IMPLICATIONS FOR INVESTORS

I have been buying stocks and bonds for many years, and I think I've bottom-ticked a purchase maybe three times. Where I am far more confident is that catching each of these bottoms was pure luck and not the intent of the purchase.

Calling bottoms is next to impossible to do on a consistent basis, so don't even bother trying. Wait for a trend to reverse, and accept the fact that you won't catch all of the upside.

Oh, and in those rare moments when you do catch a bottom, suppress the desire to run victory laps around anyone who will listen, because it will only fuel the fire for you to go find the next bottom.

The bottom line is that there's a big difference between taking risk and managing risk, and your well-being will be far better served by focusing on the latter of the two.

Sincerely,

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