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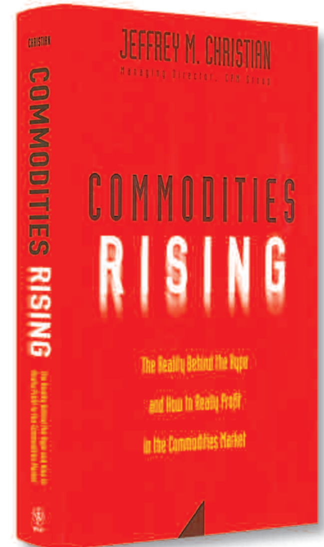
Personal Finance

The Reality Behind the Hype and How to Really Profit in the Commodities Market

Commodities Rising



By Jeffrey M. Christian

THE SUMMARY IN BRIEF

Commodities are the building blocks of the world economy and financial markets. They are the wheat that travels from the fields of Kansas to the bakers of North Africa. They are the timber from far eastern Russia that travels to furniture makers in North Carolina. They are the oil pumped from the Middle East that is refined and put into your gas tank. Commodities, as Jeffrey M. Christian succinctly puts it, are "stuff" — stuff we use every day, stuff we might not even think about as investments, but which are nevertheless traded around the globe, accounting for billions in venture dollars spent here and abroad.

It is in and around this trading that Christian, managing director of the CPM Group (a New York-based consulting firm specializing in commodities research), sees a great deal of money changing hands, as well as a great deal of misinformation being spread. In *Commodities Rising*, he explains in detail how commodities markets work and shares his strategies for long- and short-term investment. He tells how to best incorporate commodities into a well-balanced portfolio. He also addresses and debunks the many myths that circulate about the market and its major players. And along with his current portrait of this volatile yet profitable market, he offers a glimpse of what the future might hold.

IN THIS SUMMARY, YOU WILL LEARN:

- Why now is a good time to invest in commodities.
- The specific pitfalls to avoid in commodities investing.
- How commodities can be used to reduce risk and increase returns.
- How to separate good commodities information from bad.
- Why commodities are profit-generators.
- Details about specific commodities, such as gold, silver, petroleum, corn and others.
- The many ways to invest in commodities, including physicals, equities, forwards and options.

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THE COMPLETE SUMMARY: **COMMODITIES RISING**

By Jeffrey M. Christian

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The Commodities Rush Is On

Commodities are things. They are stuff. They are the building blocks of the real economy. They are called tangible assets in the financial markets, along with real estate and art. These markets are often seen as more interesting than equity and bond markets because they are tangible, a trait that attracts a certain kind of investor.

Commodities prices have risen sharply since 2003, a fact attributed to an increased use of basic commodities in China and other developing countries, as well as increases in actual demand within both developing countries and industrialized nations (including the United States and Japan) alike. Still, the majority of investors who get involved in futures contracts to buy or sell commodities at a specific price at some point in the future lose money, in large part because they approach these markets with many misconceptions about commodities and fail to do their homework both before and while they are involved in the futures markets.

There is, however, a great deal of money to be made in the commodities market — from gold and oil to wheat and coffee — by investors and traders who do their homework and avoid getting caught up in the market hype; who, in other words, keep a level head about expectations and perform the due diligence required to succeed. In commodities markets, as well as in the broader economy, the investors who do the best over the next few years will be those who are as willing to sell markets short, betting prices will fall, as they are to go long, betting prices will rise. Shorting, of course, takes a special psychological composition — one that is unafraid to sell in the face of market optimism.

Why Commodities? Why Now?

In the past few years, commodities have captured much of the center stage in international financial markets. There are three major reasons for the current rush into commodities:

• **The risk is deemed worth it.** World economic, financial and political trends and conditions have turned hostile since 2000; consequently, stocks and bonds have not done so well during the period between then and now. Investors have taken on greater risks in the search for investment returns, and one of those risks has been to move into commodities.

• **Their maturity as investments.** Commodities were traditionally disparaged by financial markets, which saw them as too volatile and complex to analyze. Today, commodities have gained new respectability and desirability as assets, comparable to stocks or bonds. They can compete in terms of capital appreciation potential, generate profits themselves and are useful as elements of a diversified portfolio.

• **The usual rise and fall.** Commodities prices have been rising, and investors chase rising prices. In any other segment of the economy, rising prices lead to lower demand, and vice versa. Investment demand, however, is positively correlated to prices: Investors buy more of investments as prices rise, and less as prices fall.

Avoiding the Pitfalls

A great deal of money will be made by investors and others in commodities over the next few years — and a great deal of money will be lost by other investors in commodities over the same period of time. Those who make money will be more nimble investors who buy and sell commodities based on reasoned and rational analysis of supply, demand and economic trends.

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The commodities markets are often misunderstood, even by many of the largest and most central participants. It's not unusual to find mining executives, for example, who do not understand even the basics of how their metal is traded internationally. Some think that, in order to get gold prices to rise, the sale of gold jewelry must rise; in truth, the demand for gold investment must rise in order for the price of gold to lift. This kind of lack of basic knowledge is not unusual (and not unique to the gold market). There are numerous reasons for the prevalence of bad information in the commodities markets, including:

• **Lack of Regulation.** Commodities markets are largely unregulated and overrun by incredibly bad information often passed off on the market by seemingly legitimate groups that simply do not know what they're talking about. This is known as fabricating statistics.

• **Faulty Statistics and the Asymmetrical Market.** The quality and accuracy of available statistics on commodities is dreadful. Commodities markets are asymmetrical, which means information is not readily available or uniformly available across the market, so some people know a lot more than others. The commodities markets are inefficient because they are ill reported, relatively small, populated by relatively fewer numbers of market participants and relatively illiquid.

• **Marketing Hype.** Much of the rhetoric that investors are hearing today about why they should be loading up on commodities has been around for decades. Much of it is just wrong.

The Myths Of The Commodities Supercycle

Many investors and others, who have marginal expertise in the commodities markets, have come forth with a wealth of profound, albeit inaccurate, advice as to how to profit from a coming "supercycle" in commodities prices. The degree of misinformation contained in some of the messages being circulated by these new gurus is astounding and appalling — unfortunately, such statements often go unchallenged and are accepted as truth. The idea that informs all the hype about supercycles is that commodities prices have begun rising sharply over the past two or three years and now are embarking on a long-term upward trend toward historically high levels.

Much of the rhetoric that is stirring up investor interest in commodities is strongly reminiscent of the "new economic paradigm" jingoism that surrounded the late stages of the bull market in equities in the late 1990s. At that time, equity market commentators spoke of a new economic reality that precluded recessions and that would be characterized by eternally rising equity values. That house of cards, of course, collapsed spectacularly.

There are several major problems to this thesis. First, it flies in the face of economic realities — higher prices tend to stimulate increases in supply and to decrease the use of a good or service. There also has been a major increase in exploration, development and expansion in a wide range of commodities, which is likely to increase supplies over time. These economic mechanisms tend to serve as a brake on rising prices.

What Has Actually Changed in Commodities Markets?

The current upward movement in commodities prices is a natural reaction to an extended period of time in which commodities prices were depressed. For some commodities, it has further to go; for others, there are signs it is already overdone. In addition, there have been some major changes on the demand side of most commodities markets that have inspired a rise in commodities prices. The key changes include:

• **Deregulation.** There has been a move in India, China and other countries toward deregulated markets, allowing for a more rapid expansion in industrial output and final demand and the emergence of domestic consumer classes to buy goods and services. This has increased total demand overall for many commodities.

• **Investment.** There has been an upward shift of the investment demand curve, as investors — including many institutional fund managers who have never touched commodities — have moved into investing in commodities.

• **Supply Curve.** While fabrication and investment demand have shifted to higher levels, the long period of under-investment in production has caused the supply of many commodities to lag.

The Myth of the Chinese Consumer Giant

Economic development has boosted overall activity in China. It has also stimulated tremendous growth in demand for basic commodities as raw materials for China's industry for goods manufactured both for export and for domestic consumption. China has become an economic powerhouse. Part of the current hoopla about commodities among investors relates to the concept that Chinese demand for a wide range of goods will lead to an unrelenting and irreversible

growth in demand for these goods. Although there is some truth to this, there is much more sizzle than there is steak in this story.

Let's separate facts from the hype. While there is an urban consumer class emerging in many parts of China, there are not 1.3 billion people suddenly rushing out to buy cars, washing machines and other items that require copper, steel, gold, platinum and other materials. There is tremendous income disparity within China, and the gulf between the haves and have-nots is widening. Most Chinese households cannot afford cars, or washing machines or many of the consumer goods common in the West.

Chinese production is also a factor in why the hype is unlikely to pan out. The commodities bulls focus on China's textile growth and its need for cotton, conveniently overlooking the rapid increase in China's cotton growing in recent years. The bulls look at China's increased copper and aluminum consumption, overlooking the fact that the country's domestic productive capacity is rising even further and faster, to the point that China is shifting from a net importer to a net exporter of such materials.

Yes, China is emerging as a major market for many commodities, but enthusiasm must be tempered about what this means for markets. In many markets, from steel to silver, China is increasing not only its domestic raw material requirements but also its own domestic productive capacity.

Commodities And The Global Economy

Many market observers have used commodities, both in general and individually, as indicators of overall economic conditions, as a leading indicator of inflation or as barometers of overall economic activity and health. This may not be wise, as the conventional wisdom of a relationship between commodity prices and overall economic conditions does not hold up to quantitative analysis.

Commodity prices also historically have been much more volatile than general price inflation. While inflation at times has moved broadly in line with commodity prices, statistical evidence suggests that the relationship is not a very tight one.

People tend to look at commodity prices as indicators of future inflation for several reasons. For one, a long time ago, commodity prices were more important to the general economy, and there is a traditional view that commodity prices are indicative of broader economic trends. Another reason is that many commodities are traded on public futures exchanges, which allows price increases to show up more quickly and more prominently than in other sectors of the economy.

Commodities and Economic Output

Clearly, there is a relationship between demand for commodities and overall economic activity levels. As real economic activity expands, people and companies are using more commodities. As disposable incomes rise, people buy more things, most of which are made out of some commodity. Thus, demand for commodities tends to rise and fall in line with real economic activity.

The relationship is very complex, however, and it is not a one-for-one move. Technological changes increase and decrease the need for individual commodities, both in individual products and industries and in relationship to broader economic activity. As intensity of demand fluctuates, changes in economic activity have a greater or lesser effect on commodity demand and prices. There is no simple formula or pattern that explains or predicts the relationship between commodity prices and real economic activity. Not only is there no clear statistical relationship, but the lags and leads between the two shift dramatically from time to time.

Commodities and Economic Development

It may surprise people who view the world economy today as a post-industrial, information-based economy, but basic commodities remain a vitally important part of economic development and international trade. Basic industries and basic commodities are often overlooked in efforts to foster economic development; this is unfortunate. It is clear that if a country has natural resources that can be developed and used, it is better off in the long run if it develops the resources it has. Unfortunately, many executives and economists involved in international development belittle the concept of natural resource development.

Information and Knowledge

Information is critical to commodity markets, as it is to all markets and commerce. Knowledge — understanding what to make of all that information — is even more critical. Both accurate information and substantive knowledge are in relatively short supply in the commodities markets. Management scientists talk about organizational systems that learn, meaning corporations,

industries and markets that effectively develop and manage a set of collective information and knowledge. The commodities markets are learning slowly and haltingly and have not been efficient in this regard in recent decades.

The commodities markets are strewn with terribly expensive, destructive mistakes rooted in a lack of information, lack of knowledge, lack of understanding and lack of analysis. The coffee market, for example, has been destroyed for many years to come by massive over-investment in poor-quality plantations that have glutted the markets. Similar patterns occur repeatedly in other markets.

These conditions exist in large part because basic commodities industries and markets have been victims of neglect and under-investment for years. It also reflects misguided government policies and academic theories that significantly underestimate the importance of basic commodities, even in advanced industrial economies. The fact that most governments, international governmental agencies, nongovernmental organizations and corporations ignore commodities means that the collective will, wisdom and investment necessary to implement effective reform is not present in these industries.

Improving Conditions

There are efforts under way to improve the use of information and knowledge in commodities markets worldwide. One set of projects is represented by the collective efforts of the World Bank, the United Nations Conference on Trade and Development (UNCTAD), the European Union, the Common Fund for Commodities and other international organizations, to try to develop a bridge between developing countries' commodities producers and processors, on one hand, and the international commodity finance markets on the other.

The European Union started the program in 1997 by seeking a replacement for commodity price support programs that were costly and ineffectual. This led to the creation of the International Task Force on Commodity Risk Management, managed by the World Bank and joined by numerous other organizations. Educational services, training and information dissemination are needed to assist commodity producers in learning how to use hedging tools effectively. An honest broker and facilitator can help commodity producers learn to use what instruments are available. ●

Commodities As An Asset Class

Commodities have become an asset class, in the words of the marketing departments on Wall Street. Many institutional fund managers have moved into commodities, in many cases for the first time ever. Another new development has been the release of some academic and market research quantitatively discussing the validity and usefulness of commodities as investment vehicles.

Commodities traditionally have been seen as something less than full-fledged investment-grade assets by many mainstream financial market types. That is one reason why larger investment banks, brokerage houses and others call them, even today, *alternative* assets, which are, for many reasons, becoming more acceptable in polite financial circles.

Commodities have at least two very important roles to play in investment portfolios:

- They can generate profits in and of themselves, through capital appreciation. Studies have shown what ample empirical evidence has well illustrated, that great wealth can be generated by investing in commodities.
- Commodities perform very well as part of a diversified portfolio of investments. Commodities generally have a very low statistical correlation to other investment assets such as stocks and bonds. This does not mean that they move in the opposite direction from stocks and bonds. It means that over time they move randomly relative to these other assets. Sometimes they all rise together, sometimes they all fall together and sometimes they move in opposite directions. This is what you want in a portfolio diversifier.

Commodities on Their Own

For long stretches of the 1980s and 1990s, many commodities did not make sense as investments, unless you were either facile at short-term trading or willing to go short the commodities. Platinum did pretty well, but gold fared terribly, particularly in the 1990s. One of the problems with traditional comparative return studies is that they tend to compare individual commodities to baskets of 500 stocks. That is not fair, nevertheless, it is commonly done.

The real key comes when you take a long-term view. Comparisons of the returns and risks of various commodities and commodities indexes to stocks, bonds, bills and stock market indexes over the long run show that commodities stand up very well in comparison. Stocks, generally speaking, did poorly in the 1970s, but soared in the 1980s and 1990s. They have not fared as

well since 1999. Commodities did well in the 1970s, partly because stocks did so poorly and partly because the prices of many important commodities, from gold and silver to oil and gas, were heavily regulated, controlled, fixed or managed by governments. As those practices ended, commodities prices played catch-up with inflation. If you include the 1970s and the current decade so far, commodities start looking more attractive compared to stocks.

Over the long run, commodities can make sense as standalone investments. One has to be careful to invest wisely, but commodities can clearly compete head-to-head with stocks and other more traditional investment assets.

Commodity Investment Vehicles

There are a number of ways to purchase commodities, both directly investing in commodities and indirectly buying exposure to commodities process through the stocks of commodities-producing companies, special investment vehicles and commodities-oriented investment funds. One can purchase physical commodities, futures contracts and forward contracts, as well as options and other investment vehicles. Common approaches include the following:

Physicals

The purest and most straightforward approach to commodities investment is, of course, to purchase the commodity outright. This is often done with gold, silver, platinum — the precious metals that also serve as financial assets. It is relatively easy to store precious metals, since they have a high value relative to their volume. They are also relatively more available in physical form for investors than are many other commodities.

It's also possible to purchase physical metals used in some of the more esoteric markets, such as rhodium, iridium, ruthenium, bismuth and cobalt. Buying these metals may be relatively difficult but doable, but selling them at some future time, when the market has either risen in your favor or fallen at your expense, could prove difficult, even impossible. It takes a special breed of investors to be willing and able to understand and take on the sorts of risks inherent to such investment vehicles.

Futures

Most investors focus on exchange-traded futures as the way to invest in commodities. While physical purchases do not make sense, many investors prefer the leveraged exposure to commodities prices that futures offer.

A futures contract is an agreement to later buy or sell a commodity in a standardized amount, quality grade, and so on, under the terms and conditions of an organized futures exchange. U.S. futures exchanges trade standard-sized contracts. They have a clearinghouse established to assure creditworthiness of all registered market participants. The trades occur through the clearinghouse and not on a principal-to-principal basis. Futures are offered on a wide range of commodities, though not on some of the more esoteric commodities.

Forwards

A forward contract is basically similar to a futures contract, except that forwards are not traded on any organized futures exchange. Forwards are principal-to-principal (between two parties) contracts, usually with a dealer or bank on one side and an investor, user or producer on the other. Forward transactions can be customized to meet a specific client need in terms of delivery points, grade, volume, type of material and so on. A forward contract is a cash market transaction. Producers and others can sell on a forward basis, while consumers and others can buy on a forward basis.

Options

Options are contracts that give buyers the right, but not the obligation, to buy or sell a commodity. Options are sold both on organized exchanges and over the counter by dealers and banks. A lot of market nomenclature surrounds options. It is no wonder that investors getting involved in exchange-traded options must sign a paper that says they understand options.

There are three broad categories of options. The buyer of a call option has the right to buy, or call for, a commodity. The buyer of a put option has the right to sell that commodity or put it on the market. The third category is compound options, which consist of combinations of puts and calls. The potential combinations (and their revenue impacts) are endless.

Exchange Traded Funds

These are relatively new investment vehicles for commodities. Exchange traded funds have exploded in the equities market where they consist of baskets of stocks that investors can buy into. In the early part of this decade, some gold market people decided to create a gold ETF that would invest solely in physical gold held in allocated accounts and would be designed to track physical gold prices as closely as possible. The

concept was based on the reality that many investors, including institutional investment fund companies, did not invest in gold bullion because it was too unusual, or cumbersome, compared to their typical equity and bond investments. The gold ETFs appear to have been initial successes, attracting larger institutional investment firms that did not invest in gold previously.

Equities

Investors often use the equities of producing companies to build exposure to commodities prices. This works for oil and gas companies, coal companies and mining companies. It is not a pure way to invest in commodities, however, as there are a number of complications. Investing in a commodities-producing company involves taking risks related to the company's management, the quality of its properties and deposits, country risk in the places where it operates, geological risk and more. Beyond mining and energy products, the ability to invest in commodities through the equities of producers is much more limited.

Mutual Funds

Sector-specific mutual funds are available, but they tend to be too rigidly managed, often due to restrictive charters. They tend to be long-only, not allowed to short these markets when prices seem too high or likely to fall. The also are often limited to investing in equities and equity options.

Commodity Funds

Most commodity funds spend most of their time and attention on financial futures. Most are also technically oriented funds, trading based on price charts, momentum indicators and so-called "black box" computerized trading strategies they have devised. These might not appeal to you if you like fundamentals and macroeconomic factors.

Hedge Funds

Most hedge funds — and there are thousands of them — do many things and, generally speaking, commodities represent a small portion of their portfolio. The best hedge funds have total discretion as to which assets and markets they invest in, and they are allowed to be both long and short. ●

Precious Metals

There are dozens of commodities in which one can invest. One has to invest the time to understand the markets, however. Otherwise sober investors often seem to throw logic, wisdom and their best analytical processes to the wind when it comes to investing in commodities. Investors who follow extremely rigorous and disciplined fundamental methodologies for investing in stocks seem to believe that when it comes to commodities, there are easy earnings to be had. They read an incredible report from an unknown person on the Internet and throw money at the wildest concepts in commodities. If they were to read a similar report about a stock, they would run for the hills.

Below are discussions of several precious-metal commodities.

Gold

Gold is the granddaddy of all commodities. It has been the single most intensely pursued commodity in the history of mankind, the stuff that dreams are made of. As a commodity, gold is used primarily in jewelry, but also in a host of industrial applications, from electronic components to coating for reflectors used in industrial ovens to bake paint onto metal.

Gold is a relatively small part of the overall physical commodities market, but the largest part of the commodities investment pool. This means that there are a lot more ways to invest in gold than there are in other commodities and a lot greater liquidity in gold investments than in comparable commodities-oriented investment sectors. Gold is purchased in the forms of gold bullion coins, numismatic coins, bars, ingots and other bullion forms. It is also purchased in futures, options, over-the-counter forwards and other derivatives. Many investors never purchase gold, per se, but invest in gold mining equities or mutual funds that specialize in gold, precious metals or natural resources.

Silver

Silver, like gold, is both a commodity and a financial asset, though it behaves more like the latter than it does the former. A tremendous amount of silver trades every day, far in excess of what one would expect based on the fundamentals of supply and demand. As a result, its price is extremely volatile. Some see silver as a "high-octane" gold, in that silver's price tends to outpace gold in percentage terms. Silver prices rise when supply and demand would send the price of a more typical commodity lower, and fall when market observers think it ought to be rising. Whatever you think you know about silver, you do not know enough to accurately call this metal's price patterns on a consistent basis, over the long run.

Like gold, silver is a major investment product. There are physical silver investment products (100- and 1,000-ounce bars), as well as medallions and coins minted by refiners and the U.S. and Canadian national mints. Silver futures and options are traded on the New York Comex, the Tokyo Commodities Exchange and the Chicago Board of Trade (CBOT). Silver equities are also a common way for investors to buy exposure to silver prices.

Energy Commodities

Energy commodities include petroleum, natural gas and uranium. Uranium is not traded on a futures exchange, but it has been of particular interest to investors lately and is likely to continue to be interesting.

Petroleum

Petroleum prices have risen sharply recently, and the commodity's price outlook was probably less ascertainable than ever before as of late 2005 and early 2006. Predictions as to future prices from respectable sources ranged from $25 to $100, and that is excluding the fringe crazies. Overall, however, prices are expected to remain strong. That doesn't mean they will continue to rise at the pace seen since 2003, nor does it mean prices will rise to $100 and stay there. It means that prices could rise to $100 in a spike and fall back to a new base of $35, $40 or maybe even higher.

One point to make clear is that economics still apply. Everyone who can is drilling for oil and they will find it. This, coupled with a modest slowing in the rate of demand will help prices come lower.

The world is consuming around 84 million barrels per day at present. Supply and demand are rather closely matched. World oil consumption has been rising at an accelerating pace over the past two decades. Add to this equation the fact that China was producing about 3.5 million barrels a day in 2005, but consuming up to 6.9 million barrels a day, making the nation a critical focus as a source of rising demand.

Investors can invest in petroleum through a number of vehicles. Oil is traded primarily on the New York Mercantile Exchange (Nymex) and the International Petroleum Exchange (IPE). There are numerous oil- and gas-producing companies, and an even greater number of exploration and development companies. There are petroleum trusts, a range of equity vehicles and energy-oriented mutual funds.

Grains And Oilseeds

Corn, soybeans and wheat are among the largest agricultural commodities markets in the world. The fact that these crops, like cotton, are newly planted every year means that farmers have flexibility in responding to changes in demand and price.

Corn

Corn is the single largest grain crop in the world. It is grown around the world, but the United States is the largest producer and consumer by a wide margin. Corn prices have spent most of the period since the early 1970s trading between $2.00 and $3.00 per bushel. Recent prices have fluctuated; prices spiked to around $4.86 in 1996 but fell to $2.00 in late 2005. Prices recovered to around $2.10 to $2.20 in early 2006. At this time, many corn market participants expected corn prices to drop into a range of $1.60 to $2.20, reflecting higher output, lower U.S. exports and high market inventories.

Corn futures and options are traded on the CBOT. This is the largest corn futures market, and the focal point for most U.S. investors and traders. Corn is also traded on the Bolsa de Mercadorias y Futuros in Brazil. Smaller futures markets exist in Budapest, France, Korea, Japan and Argentina.

The Fundamentals Still Apply

The fundamentals still matter in determining commodity price levels and trends. Nonetheless, many analysts and other market participants do not fully understand what the fundamentals are in each commodity market. Also, the measurement of these fundamentals is much poorer than most analysts and observers realize. Lastly, the relationships of various fundamentals, exogenous variables and price movements are complex and do not lend themselves to simple explanations and analyses.

The future of commodities as investments is neither boom nor bust. But investors need to do their homework. Commodities lend themselves to honest analysis, and such honest work can be rewarded with handsome returns.