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Five Myths About Commodities Investing

It might be time to diversify your portfolio, but first, understand what you're getting into

By Suzanne McGee
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Gold prices are hovering near 52-week highs, propelled upward by speculation that Federal Reserve policy makers will cut interest rates. Swine flu is wreaking havoc in China, the world's largest pork producer, boosting prices for lean-hog futures. Corn and other agricultural commodities are trading at or near their three-year highs, thanks to cool, rainy weather in the U.S. and floods that have delayed planting and raised fears of meager harvests.

Trends like these encouraged Citigroup 's commodities research team to publish a detailed, upbeat 158-page analysis in April, "Springtime for Commodities." The Citi team declares that there's a "sunnier picture ahead" even for some kinds of energy commodities, like U.S. natural gas, which has been in the doldrums for several months.

Does this mean it's a great time to diversify your portfolio to include a commodities-related fund, especially as the number of new products in this sector continues to grow?

Possibly—but be wary of the myriad claims the fierce proponents of commodities investing make when supporting their favorite asset class. Some of those claims may be true, but others are little more than myths.

MYTH 1: Commodities are an asset class, in the same way that stocks and bonds are, and should automatically be included in your long-term asset allocation.

Plenty of academic studies support the first part of this statement: Commodities possess most characteristics of an asset class, offering distinctive return patterns that often zig when other markets zag. A proliferation of new index-based products continues to make commodities even more liquid and investible with every year that passes.

But unlike stocks and bonds, commodities don't generate earnings, produce dividends or deliver interest income. Instead, to make money, you need a supply/demand imbalance to materialize in one or many different markets (corn, wheat, coffee, copper, etc.). That kind of imbalance, as well as its impact on prices, is notoriously difficult to predict, and often produces significant volatility that can unnerve investors. Also, many commodity funds levy higher expense ratios and/or other fees than their stock or bond counterparts.

"We would think of commodities as an opportunistic asset; sometimes you are in and sometimes you are out of them, depending on the outlook for specific commodities," says Scott Opsal, director of research at Leuthold Group, an independent market-research firm in Minneapolis. "They just aren't a buy-and-hold kind of asset class."

MYTH 2: Commodities are a reliable hedge against inflation.

Commodities can act as an inflation hedge, but it's far from certain that they will. A Vanguard Group research report published last year concluded that commodities, at best, are "inflation sensitive": They can generate big returns for investors when inflation isn't anticipated and arrives unexpectedly. Otherwise, it's a bit of a crapshoot.

There's a reason Vanguard will include Treasury inflation-protected securities, or TIPS—bonds structured so that their value rises along with inflation—in the Vanguard Commodity Strategy Fund it plans to roll out this month: TIPS are correlated more closely than commodities with both anticipated and unexpected inflation. Over the longest time horizons, Vanguard said in its most recent commodities research published in May, stocks fare better against inflation and "may be the ultimate protection" against rising prices.

Gold bugs are still big advocates of hanging on to bullion as a way to shield yourself from inflation shocks. Alex Bryan, director of passive-strategies research for North America at Morningstar Inc., disagrees. "You can fare better with stocks or bonds, including TIPS, as inflation hedges. And they are less risky and volatile" than a fund based on gold or commodities, he says. (Data going back decades show that stocks are a better inflation hedge than gold, at least over periods of more than a year or two.)

MYTH 3: If you invest in a commodity fund, you're getting direct exposure to the commodity itself.

In a handful of cases, like SPDR Gold Shares ETF (GLD), that may be true. Because GLD invests in gold bullion, its price will track spot gold or gold futures more closely than many other products. But it gets too complex and costly for ETF providers to maintain warehouses full of grain, copper or coffee beans, much less a big stockpile of crude oil or a storage facility full of natural gas. That explains why, for instance, if you want energy exposure, you're likely to end up owning ETFs either structured as a commodity pool—like U.S. Oil (USO)—that invests in futures contracts to track a natural-gas, crude-oil or other index, or a fund that invests in stocks to track the share prices of 150 or more energy-producing companies, like Vanguard Energy ETF (VDE). Opting for the latter means you are adding business risk to the commodity-price risk.

When you do obtain exposure to a commodity or basket of them via futures contracts, the structure of the funds means it's still not a pure play. That's because managers use some of the fund's assets to buy Treasury bills to post collateral for those futures contracts (which are pledges to deliver or to purchase a commodity at a fixed price on a future date). "A big part of the return from commodity futures is actually from the collateral invested in T-bills," says Morningstar's Mr. Bryan. Now that T-bill returns are low, he says this is one of the reasons existing investors can find their fund's performance underwhelming and the gap between their own returns and the performance of the underlying commodity sizable.

MYTH 4: Most broad-based commodity index funds will deliver similar returns.

"I'll have new clients tell me that they're investing in commodities, but without more detail, that's about as useful as them saying, 'I own fixed-income investments' without explaining how it's broken down between Treasury bonds, munis or high-yield [junk bond] securities," says Ryan Marshall, a partner at Ela Financial in Wyckoff, N.J.

There are gold indexes and energy indexes. There are narrow indexes and broad, widely diversified benchmarks. And the weighting of different components can vary. For instance, the S&P GSCI commodity index (a diverse index that emphasizes the economic importance of each

product) can end up looking like an energy index, with two-thirds or more of the commodities exposure based on what happens to crude oil, natural gas and related products. At the other end of the spectrum, the Bloomberg Commodity Index consists of 22 different products in seven sectors; no sector can account for more than a third of the index at any time. Then there's the Deutsche Bank commodities index, which emphasizes liquidity: Its six components are the most heavily traded commodities futures contracts in existence.

Even apparently analogous funds can deliver different results. Consider two energy funds, both of which employ crude-oil and natural-gas futures contracts. One may concentrate on short-term contracts, while the other uses futures dated as much as 12 months in the future. Historically, three-month futures and 12-month contracts have quite different prices, and the resulting price curve can vary significantly over time, producing different results even if spot energy prices trend higher.

Then, too, if you invest in a broad commodities fund that happens to overweight the one commodity that's doing poorly while others thrive, you'll inevitably be disappointed when you compare your returns to those for commodities as a whole. That's why Mr. Opsal advocates focusing on commodity subgroups that investors believe are likely to outperform in the shorter to medium term, rather than taking a broad approach. "If you're investing in commodities because you think this year's harvests will disappoint, you want to be paid for that" if you are right, instead of having lackluster returns on energy and metals offset your profits in a diverse fund, he says.

MYTH 5: Commodities aren't speculative in nature.

Actually, few asset classes are more speculative, unless you decide that bitcoin is an asset class. "They are guaranteed to be unpredictable," says Ashley Folkes, Phoenix-based senior vice president of investments for wealth-management firm Moors & Cabot of Boston.

That's because you're simply betting on the price or prices of one or several commodities, which can move violently in response to news events about supply and demand—or might not react at all.

Some advisers think this is still a worthwhile activity, whether it's labeled a speculative, short-term investment or a long-term core holding. "For some clients, it's a great way to diversify," says Mr. Folkes, noting how commodities can move opposite to other asset classes. And it's an approach that makes sense to his clients once he explains that they're investing in the price movements of products that they eat or otherwise consume every day—this demystifies commodities as an investment concept, he says.

Others focus on the recent underwhelming results from investing in commodities as one reason for investors to consider alternatives in pursuit of their portfolio strategies. "If the asset I'm using as a diversifier is one that has zero or little long-term growth prospects, and it's a volatile asset, I would much rather add a municipal bond fund" to play that role, argues Ian Weinberg, chief executive of Family Wealth & Pension Management in Woodbury, N.Y.

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