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February 28th, 2017

Last year for my February commentary we discussed oil and the oil industry, and re-reading it made me think more about commodities in general as an asset class that can be invested in, possibly as a hedge against inflation. As an asset class, commodities have been much maligned in recent years due to poor returns. The recent bump in long-term interest rates as well as the political debate about expanding economic growth raises the thought that inflation could be rising in the future. I think it is now worth taking a look at what commodities are, and how we invest in them.

Commodities represent one of the three basic building blocks (the others are capital and labor) of our economic system, and are present in virtually every tangible object we buy and own. Most commodities we purchase receive some form of processing along the trail that takes them to us. This might be as simple as cutting up a steer into steaks and roasts to the more complex processes of refining crude oil into gasoline or alloying aluminum to make aircraft-grade metals. You may love your steak for dinner or toast in the morning, but would probably turn up your nose at having to buy your own raw wheat grains to make the bread yourself or a whole side of beef to butcher.

Oil is probably the most significant commodity to look at. It dominates the news because it is so important to the global economy, but it is only one of dozens that are valuable enough to get the attention of financial traders. Other energy commodities include natural gas, propane, ethanol and derivatives of commodities such as gasoline and heating oil. Agricultural commodities (sometimes referred to as “softs”) range from grains to oilseeds to coffee and cocoa. Even frozen concentrated orange juice can be traded.

Industrial metals make up an important category, and most of the metals that go into the things you buy are included in commodities trading. Copper is a closely watched bellwether, as it tends to track economic growth and might serve as an indicator of good or bad times to come. Precious metals also get a lot of attention, particularly gold.

Investing in commodities is interesting and can be done in several ways. One can invest in physical holdings of commodities, and while this might seem logical it is usually only done at an industrial scale by companies who use commodities in their manufacturing operations. Occasionally a financier stockpiles commodities for investment purposes, though this can be risky. In 1979, the brothers Nelson and Herbert Hunt (oil billionaires from Texas) tried to corner the market on silver. They accumulated about 100 million troy ounces of the stuff and drove the price up from $6 at the start of 1979 to nearly $50 in January 1980. The Hunts owned so much silver that Tiffany’s took out a full page ad in the New York Times condemning their actions. The Hunts borrowed heavily (using margin) to buy their silver. A change to reduce the allowable use of margin at the commodity exchange combined with a drop in the price forced the Hunts to sell and take big losses. This brought the Hunts to their knees and eventually they were forced to file for bankruptcy.

Investors can trade in commodities more easily by using futures contracts, which simply represent an obligation to buy or sell a set quantity of a commodity at a future date. As long as the investor closes out the trade before that date arrives, he or she need not take possession of or be obligated to deliver

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the commodity. Investors who trade a commodity without any intent to hold the actual material play an important role in the commodity economy, as we shall see.

We can look at farmers and food makers for a good example of this. Without the futures market, a farmer would need to sell his newly harvested crop at the market price to a food maker. The farmer as well as the food maker are at the mercy of the market price on that day. With futures contracts, a farmer can "pre-sell" part of his expected crop by selling a futures contract at a set price that obligates him to deliver once his crop is ready. The farmer gains some certainty by doing this, and often uses the money to help pay for the cost of putting in the crop. If the growing season is good and there is a bumper crop, prices at harvest time might be lower. If the contract entered into months ago was at a higher price, the farmer benefits, and if the opposite happens, the food maker benefits instead.

Food makers use futures contracts to manage their raw material costs in a way that mirrors what the farmer is trying to do. The investors who neither produce nor use the commodity serve as counterparties to both the farmer and the food maker. Since a farmer might choose to sell when a food maker is not ready to buy, the investor steps in and provides liquidity to make the trade possible.

Trading commodity futures is not a practical option for most investors, so there are other ways to get involved and potentially profit from this segment of the market. The most common approach is to buy exchange traded funds (ETFs) that invest in futures contracts of most of the popular commodities. In most cases, these ETFs simply hold the commodity futures contracts rather than actively trading them. One can also purchase ETFs that represent physical storehouses of a few commodities, such as gold and silver. The bullion is held in vaults and is owned by trusts that are in turn owned by the shareholders of the ETF.

It is possible to invest in a fund that actively trades commodity futures. In this case, the fund hires commodity trading specialists who are expert at trading particular types of commodities. The manager of the fund decides how much money to allocate to each trader based on his or her projections of, say, a potentially large wheat crop or whether a cold winter might increase natural gas demand.

Another investment avenue is to own shares in individual companies that produce commodities, such as oil, mining or agricultural products. These companies own the wells, mines and grain elevators and profit more when prices rise for what they hold and produce. For investors who aren't buying individual stocks, funds focusing on natural resources are available to own these companies for us.

For 2016, commodities had a decent return, but that was not enough to pull them out of their long-term slump. One might ask the obvious question – if commodities have been such a poor investment, why should they be in an investment portfolio at all? Commodities can serve as a storehouse of real value that can be beneficial during inflationary times, as we have seen in the past. Regular readers might be perking their ears up, thinking about buying commodities at their currently depressed levels. After all, we might choose to invoke the contrarian principle of investing and buy when others are selling. While it may prove to be a good time to buy, it is important to keep any possible investment in perspective and make sure you remain properly diversified. A conversation with your advisor about what role commodities should play in your portfolio is an important next step to take.

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