



How to Play Commodities

Don't. The best way to take advantage of moves in the commodity markets is through professionally managed funds like the ones below.

Fund Name/TICKER	3-Year Return*	Expense Ratio**
Direxion Commodity Trends Strategy Investor/DXCTX	NA	2.00%
First Eagle Gold Fund/SGDX	15.13%	1.21
Jordan Opportunity Fund/JORDX	3.00	1.41
Powershares DB Agriculture/DBA	NA	0.75
Powershares DB Commodity Index/DBC	0.02	0.83
SPDR Gold Shares/GLD	21.07	0.40
Wilmington Multi Manager Real Asset Fund A/WMMRX	-1.01	1.07
WorldCommodity Fund/WCOMX	-5.34	1.60

Data: Morningstar, Lipper; as of Dec. 14

*Annualized returns include reinvestment of dividends and capital gains; DXCTX and DBA do not have three-year returns ** Fees and expenses as a percentage of the fund's total assets

The Case for Commodities

By Lewis Braham – Fri Dec 18, 2009

Oil, gold, corn, wheat -- perhaps the most attractive thing about commodities is they seem so concrete. Investors know that a barrel of oil may be worth more or less at the end of the day, but it will never disappear. In an age when major financial institutions can go bust overnight, that holds a lot of appeal.

Since most commodities are priced in U.S. dollars, 2010 may be a good year to invest in them. That's because the Federal Reserve has kept interest rates close to zero and increased the money supply dramatically, a move some experts say will ultimately devalue the dollar and spark inflation. As the amount a dollar can purchase decreases, commodity prices rise in relative terms. "Inflation usually starts by the government printing too much money," says Victor Sperandeo, a commodities trader and developer of a commodities index called the S&P Commodity Trends Indicator (S&P CTI). "Never in its history has the U.S. printed more money. When inflation becomes visible, we will start to see stocks slow down and commodities accelerate."

Historically, commodities have proved a better short-term hedge against temporary inflationary shocks than a good long-term investment. "Commodities are cyclical," says Sperandeo. "Corn goes up and down in price. It doesn't only go up. If you held nothing but corn in your portfolio from 1930 on, you'd have only a 2% annualized return, compared to 9% for stocks." For this reason Sperandeo developed his S&P CTI index, which follows short-term trends in commodity futures, investing in those with positive trends over the past seven months while shorting, or betting against, those with negative trends. (The strategy isn't unique, but building an index product around it for individual investors is.) Because of this ability to hedge, the CTI was up 17.7% during 2008's market meltdown. The new Direxion Commodity Trends Strategy Fund tracks the index.

Yet some money managers say there is a case to be made for a long-term commodity bull market. "Historically, commodity prices have tended to decrease by 1% to 2% annually because of improvements in the technology used to harvest commodities," says Samuel Fraundorf, co-manager of the Wilmington Multi Manager Real Asset Fund (NASDAQ:[WMMRX](#) - [News](#)), a fund that invests in commodities, real estate stocks, and inflation-protected bonds. "But you have to juxtapose that with the fact that the world population continues to increase, and standards of living in emerging countries such as China and India continue to improve at rates much faster than the natural decline we've seen in commodity prices in the past. These countries have a voracious demand for commodities."

Supply Shortage

Couple increased demand with the fact that during the recent downturn capital wasn't available to develop the infrastructure to drill for more oil, dig more iron, or grow more corn, and you see how a supply shortage could occur when the economy recovers. Figuring out where the shortages will be is the main challenge. "We're focusing on commodities where the ability to increase supply has been difficult -- oil, copper, iron ore, and coal," says Jerry Jordan of the Jordan Opportunity Fund (JORDX), which has beaten 99% of its fund peers in the past three years largely thanks to a 25% exposure in commodities.

Jordan says copper stocks have rallied too hard of late and are now overvalued, but he is still a big fan of oil. He likes offshore drillers Transocean (NYSE:[RIG](#) - [News](#)) and Diamond Offshore Drilling (NYSE:[DO](#) - [News](#)). "If you want to find more oil in the next decade, it will have to come from offshore drilling, and these companies are trading at ridiculously cheap levels relative to the value of their assets," he says. "Transocean trades at about seven times forward earnings and is an 83 stock. I think it will be worth 200 by the time the oil rally is over."

Jordan also thinks grains will experience a sharp upswing in 2010. "Outside the U.S. the rest of the world is having a terrible time producing enough grains," he says. "Farmers haven't put down enough fertilizer because the cost of fertilizer has become expensive. But you can only go so long without putting nutrients in the ground before grain yields are less. At the same time there is a rising demand for meat in emerging markets, and the amount of arable land and water resources is declining."

Rather than buy agricultural stocks, Jordan owns a 5% position in the PowerShares DB Agriculture (NYSEArca:[DBA](#) - [News](#)) exchange-traded fund (ETF), which holds futures contracts that track the price of wheat, corn, soy, sugar, cattle, and hogs directly. "If you want to play agriculture, there are few ways to play it in a stock-specific way," he says. Such futures-oriented ETFs are increasingly popular with investors.

Many ETFs that track individual commodities such as oil or natural gas can be volatile. Because of this, Wilmington's Fraundorf prefers ETFs with diversified baskets of commodity futures. "We've looked at how baskets of commodities have performed over time and found them to be a much better hedge against inflation than any individual commodity," he says. Currently his fund has a 33% position in the PowerShares DB Commodity Index ETF (NYSEArca:DBC - News), a broadly diversified fund.

Going With Gold

If the dollar declines sharply, the best investment may be gold. "Gold prices aren't based on supply and demand like other commodities," says commodities trader Sperandeo. "They're based on people's desire to run away from paper currency into hard assets." He thinks price moves in other commodities may be correlated with the stock market in the short term, until inflation hits. Right now he's bearish on stocks. So Sperandeo prefers the SPDR Gold Shares ETF (GLD), which owns gold bullion directly, to investments in other commodities.

Gold stocks may not be as safe as bullion, since mining companies face special geopolitical and financial risks. But it is precisely the fear of such risks that often makes them attractively valued. "South African stocks such as Gold Fields (NYSE:GFI - News), Harmony Gold Mining (NYSE:HMY - News), and AngloGold Ashanti (NYSE:AU - News) continue to be somewhat overlooked because of their perceived geopolitical risk," says portfolio manager Rachel Benepe of First Eagle Gold Fund (NASDAQ:SGGDX - News). "But South Africa has a 25% unemployment rate, and the mining companies are its largest employer. The country can't afford to take the risk of hurting that business."

Other, less popular commodities may also present opportunities. Cotton declined for many years only to begin to recover recently along with the price of oil. "Cotton's primary competition is polyester," says Jim Llewellyn, manager of the WorldCommodity Fund (NASDAQ:WCOMX - News). "Since polyester is made from oil, as oil prices rise it becomes less compelling compared with cotton." Llewellyn's favorite in the sector is J.G. Boswell, "the largest cotton grower and one of the best-run farming operations in the world," he says. The company has a not-so-well-hidden asset in the vast quantities of water on its property in California's San Joaquin Valley. Its stock, however, is not very liquid, since the company is closely held by the Boswell family, which doesn't trade its shares much.

Llewellyn is also a fan of natural gas. He likes it as an energy play but also because it is a primary ingredient in fertilizer. "I have a strong view that there will be a shortage of fertilizer in the next 36 months," he says. He favors Canadian gas players such as Birchcliff Energy. As for investors playing these volatile commodities directly via futures, Llewellyn agrees that is best left to the pros.

Source: Businessweek Investment Outlook 2010

http://www.businessweek.com/magazine/content/09_52/b4161078184915.htm