

An Introduction to Commodities

WHAT ARE COMMODITIES?

Commodities, such as platinum, gold, wheat, corn, oil, and natural gas, are raw materials used to create the products that consumers buy. Investor interest in commodities has soared in recent years as the asset class has outperformed traditional assets such as stocks and bonds. Growing inflation fears have also contributed to recent demand, as well as a belief that insatiable demand from China, India and other emerging economies will continue to drive the need for commodities well into the future.

PORTFOLIO DIVERSIFICATION BENEFITS

Commodities have historically produced long-term rates of return that are competitive with those of stocks and bonds, while also offering protection during inflationary periods. In addition, the correlation attributes of commodities result in potential portfolio diversification benefits. In the past, commodities have not moved in tandem with other asset classes. For example, commodities generally exhibited negative correlation with both stocks and bonds for the 25-year period ending in 2008*. Due to these negative correlation attributes, the addition of commodities to a well-diversified portfolio has historically improved the overall risk and return profile for investors.

NEGATIVE CORRELATION TO STOCK AND BONDS

Commodities are “real assets,” unlike stocks and bonds, which are “financial assets.” Generally, commodity prices are negatively correlated to the prices of stocks and bonds for the following reasons:

- *Inflation:* Commodity prices tend to rise with inflation, unlike the prices of stocks and bonds, which tend to fall with inflation. This positive relationship with inflation is the main reason why investors use commodities as a tool to hedge against rising inflation.

- *Valuation:* Commodity prices are generally based on short-term supply/demand expectations, while stock and bond prices reflect long-term cash-flow expectations.

GAINING EXPOSURE TO COMMODITIES

The commodities market has evolved significantly from the days when farmers and miners sold products to the local market. Today, futures contracts exist on a wide array of agricultural products, metals, energy products, and soft commodities (i.e. sugar and cotton), and these contracts are traded on exchanges around the world.

There are several ways for investors to gain exposure to commodities. The following provides an overview of the most popular methods and some considerations for each:

Direct Investments in Physical Commodities

- Buying physical commodities and storing for future use or trade.
- Storage, transportation, and insurance costs should be considered.
- Generally not a feasible method of investing for most investors.

Stocks of Commodity-Producing Companies

- Examples include buying the stocks of companies such as ExxonMobil, Phelps Dodge, and Newmont Mining.
- Returns influenced by both company-specific risk and underlying commodity risks.
- Over time, correlation may be related more to the stock market than to the commodity market.



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An Introduction to Commodities, continued

Commodity Futures

- Generally the easiest and most common way to gain economic exposure to specific commodities.
- Exchange traded. Delivery of commodities is not required to close a futures contract.
- Investors seeking long-term exposure would need to continually re-establish futures positions.

Mutual Funds, Exchange Traded Funds (ETFs), and Exchange Traded Notes (ETNs)

- Attempt to track the performance of commodity indices (such as the Dow Jones AIG Commodity Index or the S&P GSCI).
- Provide efficient access to broad commodities markets.
- Allow for continual exposure to commodities (no need to reestablish positions).
- Broad exposure only — investors generally unable to gain exposure to specific commodity markets.

COMMODITY FUTURES SOURCES OF RETURN

There are potentially three sources of return for commodities futures contracts. These sources include:

- *Price Changes* — Reflects the change in price of the underlying commodities.
- *Collateral Yield* — Interest earned on the collateral (generally U.S. Treasury Bills) to collateralize the face amount of the futures contract.
- *Roll Yield* — Holding period return that results from the commodities futures term structure. With the passage of time, spot prices for a given commodity will approach the futures price and they will converge upon maturity.

RISKS OF COMMODITIES INVESTMENTS

It is important to understand the risks of investing in commodities. Investments in commodities may not be suitable for all investors. Below are several risks associated with investing in commodities:

- *Performance Volatility* — Commodities can be quite volatile as stand-alone investment vehicles. Long-term volatility of returns has been slightly higher than stocks. Exposure to commodities should comprise a small portion of a diversified portfolio.
- *Performance Cycles* — Commodities performance cycles (both outperformance and underperformance) relative to stocks and bonds have historically lasted for long periods of time. For example, commodities underperformed stocks for nearly a twenty year period from the early 1980s to the late 1990s.

INCORPORATING COMMODITIES INTO YOUR PORTFOLIO — INVESTMENT CONSIDERATIONS

To determine if investing in commodities is right for you, and, if so, to create an appropriate allocation to commodities, you must consider several different factors including:

- Your overall financial objectives.
- Your risk profile.
- Your investment horizon.

Your Financial Advisor can work with you to determine if investing in commodities is appropriate for you and, if so, a suitable allocation.

* Based on the performance of the S&P GSCI relative to the S&P 500 Index and Lehman Aggregate Bond Index.

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