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*Commodities*

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2ND EDITION



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**by Amine Bouchentouf**



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# *Dedication*

This book is dedicated to my most steadfast supporters — my family. You have always been there for me when I needed you and have always supported me in every endeavor I've decided to undertake. I would not have been able to accomplish half the things I've done without your tremendous support, and for that I am deeply grateful.

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# Introduction

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**W**hen I wrote the first edition of *Commodities For Dummies*, commodities were certainly not a mainstream asset class. However, five years later, commodities have grown into their own legitimate and respected asset class. Trade magazines and financial newsletters frequently include feature-length articles on the topic. Financial TV stations regularly report oil, gold, and copper prices on the crawling ticker. And no global macro money manager can claim continued success without constantly keeping a pulse on commodities. This situation wasn't true at the beginning of the century, and it's a testament to the growing importance of commodities in our globalized and globalizing world.

Why are commodities, long regarded as an inferior asset class, quickly moving to the investing mainstream? Good performance. Investors like to reward good performance, and commodities have performed well in recent years. In addition, investors can more easily access these markets: Plenty of new investment vehicles, from exchange-traded funds (ETFs) to master limited partnerships (MLPs), have been introduced to satisfy investor demand.

As commodities have been generating more interest, there's a large demand for a product to help average investors get a grip on the market fundamentals. Commodities as an asset class have been plagued by a lot of misinformation, and it's sometimes difficult to separate fact from fiction or outright fantasy. The aim of *Commodities For Dummies* is to help you figure out what commodities are all about and, more important, develop an intelligent investment strategy to profit in this market. Of course, as with every other asset class, commodities are subject to market swings and disruptions, which can be a source of risk but also an opportunity. As the 2008 Global Financial Crisis demonstrated, even the most savvy investors with the latest up-to-date market information can struggle with unique investment events.

These disruptions are part of the market process. Investors who protect themselves through a "margin of safety" philosophy will be able to protect their downside during periods of extreme volatility. Using this book, you'll better equip yourself to avoid the pitfalls inherent in any investment activity.

## About This Book

My aim in writing *Commodities For Dummies*, 2nd Edition, is to offer you a comprehensive guide to the commodities markets and show you a number of investment strategies to help you profit in this market. You don't have to invest in just crude oil or gold futures contracts to benefit. You can trade ETFs, invest in companies that process commodities such as uranium, buy precious metals ownership certificates, or invest in master limited partnerships. The commodities markets are global in nature, and so are the investment opportunities. My goal is to help you uncover these global opportunities and offer you investment ideas and tools to unlock and unleash the power of the commodities markets. Best of all, I do all of this in plain English!

Anyone who's been around commodities, even for a short period of time, realizes that folks in the business are prone to engage in linguistic acrobatics. Words like *molybdenum*, *backwardation*, and *contango* are thrown around like "hello" and "thank you." Sometimes these words seem intimidating and confusing. Don't be intimidated. Language is powerful, after all, and getting a grip on the concepts behind the words is critical, especially if you want to come out ahead in the markets. That's why I use everyday language to explain even the most abstract and arcane concepts.

Here are some of the trading and investing ideas you discover in the book:

- ✔ **Get more bang for your buck by investing through master limited partnerships, investment vehicles used by only the most sophisticated investors.** *Master limited partnerships* (MLPs), which invest in energy infrastructure such as pipelines and storage facilities, are a unique investment because they trade publicly, like a corporation, but offer the tax benefits of a partnership. Unlike corporations, which are subject to double taxation (on the corporate and shareholder levels), MLPs can pass their income to shareholders *tax free*, so shareholders are responsible for taxes only at the individual level. Because the primary mandate of MLPs is to distribute practically all the cash flow directly to shareholders, you can't afford not to invest in these hybrid vehicles. Find out how in Chapter 6.
- ✔ **Capitalize on the increasing popularity of nuclear power by investing in uranium, an investment-grade material.** The use of nuclear power to generate electricity is on the rise. As a result, the price of uranium, the primary fuel used in nuclear power plants, has been in an extended — albeit quiet — bull market for more than a decade, *quadrupling* from \$10 in 1994 to \$40 in 2006. Find out which companies mine this unique commodity and how to profit from this trend in Chapter 13.

- ✔ **Benefit from the commodity trading craze without trading a single futures contract.** As more investors flock toward the commodities markets, the exchanges that provide futures contracts, options, and other derivatives to commodity traders have seen their business expand exponentially. The Chicago Mercantile Exchange (NYSE: CME), one of the largest commodity exchanges, has seen its stock price rise from \$40 since its 2003 initial public offering to more than \$310 in 2011. (See Chapter 8 for more on how to capitalize on the success of exchanges.)
- ✔ **Capitalize on the relationship between digital cameras and the silver markets.** You may be surprised to find that the photographic industry is a major consumer of silver, accounting for almost 20 percent of total silver consumption. Traditional cameras use silver halide, a silver and halogen compound, to create photographic film. However, digital cameras, which don't require silver halide, have decreased the demand for silver in photography. Find out how to profit from this by betting against the price of silver, using a trading technique known as *going short*, which I cover in Chapter 9. (Turn to Chapter 15 for more on the silver markets.)
- ✔ **Generate a gushing stream of dividend income by investing in oil tanker stocks.** One of the best-kept secrets on Wall Street is oil tanker stocks, which provide some of the highest dividend yields in the market. Average dividend yields for some of the industry's top performers are more than 12 percent, higher than even for diversified and electric utilities (which I cover in Chapter 13).

## Conventions Used in This Book

To help you make the best use of this book, I use the following conventions:

- ✔ *Italic* is used for emphasis and to highlight new words or terms.
- ✔ **Boldfaced text** is used to indicate key words in bulleted lists or the action parts of numbered steps.
- ✔ `Monofont` is used to make Web addresses stand out for your ease.

Trading commodities requires mastering a wide variety of technical terms. The glossary tells you what all those high-sounding financial terms actually mean so you can talk the talk, too!

## *Foolish Assumptions*

In writing *Commodities For Dummies*, I made the following assumptions about you:

- ✔ You have some previous investing experience but are looking to diversify your holdings.
- ✔ You're familiar with commodities trading but want to brush up on your knowledge.
- ✔ Your traditional investments (stocks/bonds/mutual funds) haven't performed according to your expectations, and you're looking for alternatives to maximize your returns.
- ✔ You're a new investor or someone with minimal trading experience, and you're interested in a broad-based investment approach that includes commodities and other assets.
- ✔ You understand the attractiveness of commodities and want a comprehensive and easy-to-use guide to help you get started.
- ✔ You're skeptical about the benefits of commodities but want to read about them anyway. Please do — I'm confident that this book will change your mind!
- ✔ You have little or no investment experience but are eager to find out more about investing. This book not only explores investing in commodities, but also includes explanations of general investing guidelines that apply to any market.

## *How This Book Is Organized*

I've organized the book in a way that helps you look up essential information and analysis on the world's most important commodities and trading techniques. The following sections break down each part.

### *Part I: Commodities: Just the Facts*

The first part of *Commodities For Dummies*, 2nd Edition, gives you good general investing principles. Whether you're an experienced trader or a new investor, having a good grasp of basic portfolio allocation methods is crucial for your success. Find out here how to create and design an investing road map that's specifically tailored to your financial needs and goals. You also discover how commodities stack up against other investment vehicles, such as stocks and bonds.



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In addition, I explain and dispel some of the common misconceptions regarding the commodities markets, particularly relating to risk and volatility. I also include a whole chapter on identifying, managing, and overcoming risk, which may be the single most important issue you face as an investor. The fact of the matter is that any investment entails a certain degree of risk — overcoming that risk separates successful investors from the rest. Find out how you, too, can successfully minimize risk and maximize your returns with the help of commodities.

## ***Part II: Getting Started with Types of Investment Vehicles***

Get the lowdown on the best investment methods you have at your disposal to invest in commodities. I analyze the pros and cons of investing through the futures markets, the equity markets, ETFs, and mutual funds. In addition, I examine the role of the market regulators so you can know your rights as an investor, and I cover specific trading techniques and analyses, such as technical and fundamental analysis. Read this part to find out how to start trading commodities.

## ***Part III: The Power House: How to Make Money in Energy***

Energy is the largest subasset class in the commodities universe. Crude oil, for example, is the most widely traded commodity in the world today. Natural gas, coal, and nuclear power are also major commodities. In addition, I uncover investment opportunities in the alternative energy space (wind and solar power) and examine the companies responsible for providing energy to the world.

## ***Part IV: Pedal to the Metal: Investing in Metals***

Metals are grouped using two criteria: whether they contain iron and, more important, whether they resist corrosion. Metals that contain iron are called *ferrous metals*, and these include metals such as zinc. *Nonferrous metals*, such as gold, silver, and platinum, don't contain iron. On the corrosion side, the metals that don't corrode easily are usually the precious metals: gold, silver, platinum, and palladium. Base metals, like copper, nickel, and zinc, are major industrial metals. As you can tell, you find out everything you ever wanted to know about metals in this part.

## ***Part V: Going Down to the Farm: Trading Agricultural Products***

Nothing is more fundamental to human life than food. In this part, find out how you can nourish and grow your portfolio by investing in this most basic commodity. Some of the most commonly traded agricultural products include coffee, sugar, and orange juice. I help you decipher the seasonal nature of the business, analyze import/export activities, and consider potential obstacles so that you can design and execute a rock-solid investment approach. Some of the commodities I discuss in this part include orange juice, cocoa, feeder cattle, soybeans, and wheat.

## ***Part VI: The Part of Tens***

The legendary *For Dummies* Part of Tens chapters give you tips on how to become a better investor and trader. Follow the ten time-tested rules that successful commodities investors have used to make substantial profits in this area. You also get acquainted with ten of the best resources to help you become a successful commodities investor.

This book also includes a detailed glossary that covers all the major technical terminology in these pages. Investing in commodities can get fairly technical, so understanding the concepts behind the words is critical for your success as an investor.

## ***Icons Used in This Book***

One of the pleasures of writing a *For Dummies* book is that you get to use all sorts of fun, interactive tools to highlight or illustrate a point. Here are some icons that I use throughout the book:



I use this icon to highlight information that you want to keep in mind or that's referenced in other parts of the book.



When you see this icon, make sure that you read the accompanying text carefully: It includes information, analysis, or insight that will help you successfully implement an investment strategy.



I explain more technical information with this icon. The commodities markets are complex, and the vocabulary and concepts are quite tricky. You can skip these paragraphs if you just want a quick overview of the commodities world, but be sure to read them before seriously investing. They give you a better grasp of the concepts discussed.



Investing can be an extremely rewarding enterprise, but it can also be a hazardous endeavor if you're not careful. I use this icon to warn you of potential pitfalls. Stay alert for these icons because they contain information that may help you avoid losing money.



Sometimes a potential investment requires a little extra research. When you see this icon, get ready to analyze the investment with a fine-toothed comb. This icon lets you know that extensive due diligence is in order.

## *Where to Go from Here*

I've organized this book in a way that gives you the most accurate and relevant information related to investing in general and commodity investing in particular. The book is modular in nature, meaning that although it reads like a book from start to finish, you can read one chapter or even a section at a time without needing to read the whole book to understand the topic that's discussed.

If you're a true beginner, however, I recommend that you read Parts I and II carefully before you start skipping around in the chapters on particular commodities.



# Part I

## Commodities: Just the Facts

The 5<sup>th</sup> Wave

By Rich Tennant



“It’s this trend that leads us to believe we should supplement our oil commodities with investments in some of the Earth’s rich vinegar and crouton reserves.”

## *In this part . . .*

**T**he chapters in this part give you everything you've ever wanted to know about commodities. I introduce the commodities markets and go through some of the individual commodities and how they interact with each other. I also look at the risks of commodities investing, as well as how commodities as an asset class compare to other assets, such as stocks and bonds.