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Investing in Commodities

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- Break into the commodities market
- Diversify your portfolio
- Minimize risk and maximize rewards
- Start trading and making informed decisions

Amine Bouchentouf

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Contents at a Glance

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Introduction

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 *Investing in 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 savviest 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

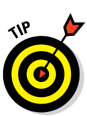
My aim in writing *Investing in Commodities For Dummies* is to offer you a comprehensive guide to the commodities markets and show you a number of investment strategies to help you profit in this market. You don't have to invest in just crude oil or gold futures contracts to benefit. You can trade ETFs, 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.

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.

Beyond the Book

In addition to all the material you can find in the book you're reading right now, this product also comes with some access-anywhere goodies on the web. Check out the eCheat Sheet at `www.dummies.com/cheatsheet/investing incommodities` for helpful insights and details about the benefits of diversification, how to decipher public disclosure forms, and the major influencer of oil markets.

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

Just the Facts on Commodities

getting started with

Investing in Commodities

Visit www.dummies.com for great Dummies content online.

In this part . . .

- Know why you should invest in commodities, check out the commodities markets, and find the best ways to invest in commodities
- Celebrate the advantages, acknowledge the downsides, and manage risk when investing in commodities

Chapter 1

Investors, Start Your Engines! An Overview of Commodities

In This Chapter

- Finding out why you should invest in commodities
- Defining the commodities markets
- Determining the best ways to trade commodities
- Identifying the major commodities

The commodities markets are broad and deep, presenting both challenges and opportunities. Investors are often overwhelmed simply by the number of commodities out there: more than 30 tradable commodities to choose from. (I cover almost all of them — 32, to be exact — more than any other introductory book on the topic.) How do you decide whether to trade crude oil or gold, sugar or palladium, natural gas or frozen concentrated orange juice, soybeans or aluminum? What about corn, feeder cattle, and silver — should you trade these commodities as well? And if you do, what's the best way to invest in them? Should you go through the futures markets, go through the equity markets, or buy the physical stuff (such as silver coins or gold bullion)? And do all commodities move in tandem, or do they perform independently of each other?

With so many variables to keep track of and options to choose from, just getting started in commodities can be daunting. Have no fear — this book provides you with the actionable information, knowledge, insight, and analysis to help you grab the commodities market by the horns. You've maybe heard a lot of myths and fantasies about commodities. I shatter some of these myths and, in the process, clear the way to help you identify the real money-making opportunities.

For example, a lot of folks equate (incorrectly) commodities exclusively with the futures markets. Undoubtedly, the two are inextricably linked — the futures markets offer a way for commercial users to hedge against commodity price risks and a means for investors and traders to profit from this price risk. However, the futures market is only one planet in the commodities universe.

The equity markets are also involved in commodities. Companies such as ExxonMobil (NYSE: XOM) focus on the production of crude oil, natural gas, and other energy products; Anglo-American PLC (NASDAQ: AAUK) focuses on mining precious metals and minerals across the globe; and Starbucks (NASDAQ: SBUX) offers investors access to the coffee markets. Ignoring these companies that process commodities isn't only narrow minded, but it's also a bit foolish because they provide exposure to the very same commodities traded on the futures market.

In addition to the futures and equity markets, a number of investment vehicles allow you to access the commodities markets. These vehicles include master limited partnerships (MLPs), exchange-traded funds (ETFs), and commodity mutual funds (all covered in Chapter 12). So although I do focus on the futures markets, I also examine investment opportunities in the equity markets and beyond.

The commodities universe is large, and investment opportunities abound. In this book, I help you explore this universe inside and out, from the open outcry trading pits on the floor of the New York Mercantile Exchange to the labor-intensive cocoa fields of the Ivory Coast; from the vast palladium-mining operations in northeastern Russia to the corn-growing farms of Iowa; from the Ultra Large Crude Carriers that transport crude oil across vast oceans to the nickel mines of Papua New Guinea; from the sugar plantations of Brazil to the steel mills of China.

By exploring this fascinating universe, not only do you get insight into the world's most crucial commodities — and get a glimpse of how the global capital markets operate — you also see how to capitalize on this information to generate profits.

Defining Commodities and Their Investment Characteristics

Just what, exactly, are commodities? Put simply, commodities are the raw materials humans use to create a livable world. Humans have been exploiting earth's natural resources since the beginning of time. They use agricultural products to feed themselves, metals to build weapons and tools, and energy to sustain themselves. Energy, metals, and agricultural products are the three classes of commodities, and they are the essential building blocks of the global economy.

For the purposes of this book, I present 32 commodities that fit a very specific definition, which I define in the following bulleted list. For example, the commodities I present must be raw materials. I don't discuss currencies — even though they trade in the futures markets — because they're not a raw material; they can't be physically used to build anything. In addition, the commodities must present real moneymaking opportunities to investors.

All the commodities I cover in the book have to meet the following criteria:

- **Tradability:** The commodity has to be tradable, meaning that there needs to be a viable investment vehicle to help you trade it. For example, I include a commodity if it has a futures contract assigned to it on one of the major exchanges, if a company processes it, or if an ETF tracks it.

  Uranium, which is an important energy commodity, isn't tracked by a futures contract, but several companies specialize in mining and processing this mineral. By investing in these companies, you get exposure to uranium.
- **Deliverability:** All the commodities have to be physically deliverable. I include crude oil because it can be delivered in barrels, and I include wheat because it can be delivered by the bushel. However, I don't include currencies, interest rates, and other financial futures contracts because they're not physical commodities.
- **Liquidity:** I don't include any commodities that trade in illiquid markets. Every commodity in the book has

an active market, with buyers and sellers constantly transacting with each other. Liquidity is critical because it gives you the option of getting in and out of an investment without having to face the difficulty of trying to find a buyer or seller for your securities.

Going for a Spin: Choosing the Right Investment Vehicle

The two most critical questions to ask yourself before getting started in commodities are the following: What commodity should I invest in? How do I invest in it? I answer the second question first and then examine which commodities to choose.

The futures markets

In the futures markets, individuals, institutions, and sometimes governments transact with each other for price-hedging and speculating purposes. An airline company, for instance, may want to use futures to enter into an agreement with a fuel company to buy a fixed amount of jet fuel for a fixed price for a fixed period of time. This transaction in the futures markets allows the airline to hedge against the volatility associated with the price of jet fuel. Although commercial users are the main players in the futures arena, traders and investors also use the futures market to profit from price volatility through various trading techniques.

TECHNICAL STUFF

One such trading technique is *arbitrage,* which takes advantage of price discrepancies between different futures markets. For example, in an arbitrage trade, you purchase and sell the crude oil futures contract simultaneously in different trading venues, for the purpose of capturing price discrepancies between these venues.

REMEMBER

The futures markets are administered by the various commodity exchanges, such as the Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE). I discuss the major exchanges, the role they play in the markets, and the products they offer in Chapter 13.

The most direct way of investing in the futures markets is to open an account with a *futures commission merchant* (FCM). The FCM is much like a traditional stock brokerage house (such as Schwab, Fidelity, or Merrill Lynch), except that it's allowed to offer products that trade on the futures markets. Here are some other ways to get involved in futures:

- **Commodity trading advisor (CTA):** The CTA is an individual or company licensed to trade futures contracts on your behalf.
- **Commodity pool operator (CPO):** The CPO is similar to a CTA, except that the CPO can manage the funds of multiple clients under one account. This pooling provides additional leverage when trading futures.
- **Commodity indexes:** A commodity index is a benchmark, similar to the Dow Jones Industrial Average or the S&P 500, that tracks a basket of the most liquid commodities. You can track the performance of a commodity index, which allows you to essentially "buy the market." A number of commodity indexes are available, including the Goldman Sachs Commodity Index and the Reuters/Jefferies CRB Index, which I cover in Chapter 12.

REMEMBER

These examples are only a few ways to access the futures markets. Be sure to read Chapters 11 and 12 for additional methods.

A number of organizations regulate the futures markets, including the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). These organizations monitor the markets to prevent market fraud and manipulation and to protect investors from such activity. Check out Chapter 13 for an in-depth analysis of the role these regulators play and how to use them to protect yourself from market fraud.

WARNING!

Trading futures isn't for everyone. By their very nature, futures markets, contracts, and products are extremely complex and require a great deal of mastery by even the most seasoned investors. If you don't feel that you have a good handle on all the concepts involved in trading futures, don't simply jump into futures — you could lose a lot more than your principal (because of the use of leverage and other characteristics unique to the futures markets). If you're not comfortable trading futures, don't sweat it. You can invest in commodities in multiple other ways.

The equity markets

Although the futures markets offer the most direct investment gateway to the commodities markets, the equity markets also offer access to these raw materials. You can invest in companies that specialize in the production, transformation, and distribution of these natural resources. If you're a stock investor familiar with the equity markets, this may be a good route for you to access the commodities markets. The only drawback of the equity markets is that you have to take into account external factors, such as management competence, tax situation, debt levels, and profit margins, which have nothing to do with the underlying commodity. That said, investing in companies that process commodities still allows you to profit from the commodities boom.

Publicly traded companies

The size, structure, and scope of the companies involved in the business are varied, and I cover most of these companies throughout the book. I offer a description of the company, including a snapshot of its financial situation, future growth prospects, and areas of operation. I then make a recommendation based on the market fundamentals of the company.

You encounter these types of companies in the book:

- **Diversified mining companies:** A number of companies focus exclusively on mining metals and minerals. Some of these companies, such as Anglo-American PLC (NASDAQ: AAUK) and BHP Billiton (NYSE: BHP), have operations across the spectrum of the metals complex, mining metals that range from gold to zinc. I look at these companies in Chapter 9.
- **Electric utilities:** Utilities are an integral part of modern life because they provide one of life's most essential necessities: electricity. They're also a good investment because they have historically offered large dividends to shareholders. Read Chapter 5 to figure out whether these companies are right for you.
- **Integrated energy companies:** These companies, such as ExxonMobil (NYSE: XOM) and Chevron (NYSE: CVX), are involved in all aspects of the energy industry, from the extraction of crude oil to the distribution of liquefied natural gas (LNG). They give you broad exposure to the energy complex (see Chapter 6).

This list is only a small sampling of the commodity companies I cover in these pages. I also analyze highly specialized companies, such as coal-mining companies (Chapter 5), oil refiners (Chapter 6), platinum-mining companies (Chapter 7), and purveyors of gourmet coffee products (Chapter 10).

Master limited partnerships

Master limited partnerships (MLPs) invest in energy infrastructure such as oil pipelines and natural gas storage facilities. I'm a big fan of MLPs because they're a *publicly traded partnership.* They offer the benefit of trading like a corporation on a public exchange, while offering the tax advantages of a private partnership. MLPs are required to transfer all cash flow back to shareholders, which makes them an attractive investment. I dissect the structure of MLPs in Chapter 12 and introduce you to some of the biggest names in the business so you can take advantage of this unique investment.

Managed funds

Sometimes it's just easier to have someone else manage your investments for you. Luckily, you can count on professional money managers who specialize in commodity trading to handle your investments.

Consider a few of these options:

- **Exchange-traded funds (ETFs):** ETFs are an increasingly popular investment because they're managed funds that offer the convenience of trading like stocks. In recent years, a plethora of ETFs has appeared to track everything from crude oil and gold to diversified commodity indexes. Find out how to benefit from these vehicles in Chapter 12.
- **Mutual funds:** If you've previously invested in mutual funds and are comfortable with them, look into adding a mutual fund that gives you exposure to the commodities markets. A number of funds are available that invest solely in commodities. I examine these commodity mutual funds in Chapter 12.

If you have a pet or a child, sometimes you hire a pet sitter or babysitter to look out after your loved ones. Before you hire this individual, you interview candidates, check their references, and examine their previous experience. When you're satisfied with the top candidate's competency, only then do you entrust that person with the responsibility of looking after your cat, daughter, or both. The same thing applies when you're shopping for a money manager, or money sitter. If you already have a money manager you trust and are happy with, stick with him. If you're looking for a new investment professional to look after your investments, you need to investigate him as thoroughly as possible. In Chapter 14, I examine the selection criteria to use when shopping for a money manager.

Physical commodity purchases

The most direct way of investing in certain commodities is to actually buy them outright. Precious metals such as gold, silver, and platinum are a great example of this. As the price of gold and silver has skyrocketed recently, you may have seen ads on TV or in newspapers from companies offering to buy your gold or silver jewelry. As gold and silver prices increase in the futures markets, they also cause prices in the spot markets to rise (and vice versa). You can cash in on this trend by buying coins, bullion, or even jewelry. I present this unique investment strategy in Chapter 7.

REMEMBER

This investment strategy is suitable for only a limited number of commodities, mostly precious metals like gold, silver, and platinum. Unless you own a farm, keeping live cattle or feeder cattle to profit from price increases doesn't make much sense. And I won't even mention commodities like crude oil or uranium!

Checking Out What's on the Menu

I cover 32 commodities in the book. Here's a listing of all the commodities you can expect to encounter while going through these pages. (Although the book is modular in nature, I list the commodities here in order of their appearance in the text.)