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Is It Time to Buy Commodities?

With prices sharply down on many comr ig be wondering: Is it time to swap stocks j

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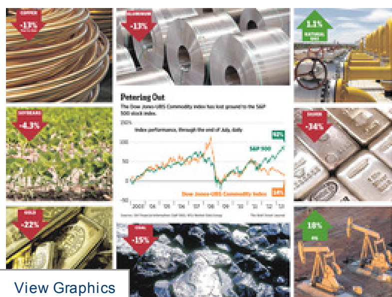
Commodities investors are missing out on the party.

Since its recent peak in September 2012, the Dow Jones-UBS UBSN.VX +0.37% Commodity Index, which includes 20 products such as natural gas, gold and copp has fallen about 14%.

During the same period, the S&P 500 stock index has taken off, returning close to 20% including dividends. And even amid all the talk of a bond-market crash, a broa based bond-market exchange-traded fund such as iShares Core Total U.S. Bond Market has lost only a few percent, while exchange-traded funds that own riskier bonds, like high-yield ones, have in some cases made money.



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That wasn't how it was supposed to play out. Between 1998 and 2008, prices of many raw materials soared, prompting investors to talk of a commodities "supercycle," a long-term boom to be driven by growth in China and other emerging markets.

But the financial crisis dealt a huge blow to commodities. Many of them have failed to regain their precrisis highs, leading some analysts to declare the supercycle dead.

Some portfolio managers like commodities because their prices don't go up and down in sync with those of stocks and bonds, thus providing a kind of hedge against their movements. But that isn't a fail-safe strategy: In 2008, for example, the DJ-UBS index plummeted 37%, the same amount as an ETF of major U.S. stocks.

Should you be tempted to buy commodities after their recent slump? If you are, there are two ways to gain exposure to raw materials: buying them through a fund, or buying companies that produce them.

Direct investments in commodities and commodity funds have two major drawbacks, say some analysts. First, they don't produce any income, meaning those who put their money in commodity assets are betting entirely on price appreciation. But commodity prices over the long haul tend to march in lockstep with inflation.

"There's no growth in commodities. So what's the point of doing this?" says Rick Ferri of Troy, Mich.-based investment manager Portfolio Solutions, which doesn't include commodities in clients' portfolios.

And even if commodities were a good long-term diversifier, it is difficult to separate the change in commodity prices—which investors want exposure to—from all of the costs and trading pitfalls inherent in the funds that own them.

Few commodity mutual funds, exchange-traded notes or other exchange-traded products actually own the soybeans, oil or metals they track. Instead, they typically own contracts that give them the right to buy commodities at a set time in the future.

On July 31, for example, the United States Oil Fund, USO -0.18% which charges 0.74%, or $74 per $10,000 invested, owned contracts giving it the right to buy West Texas Intermediate light, sweet crude oil in September. When September gets closer, the fund will replace those contracts with new ones giving it the right to buy oil in October.

Sometimes, that continued process of "rolling" one month's contract into the next adds to returns, but the process can also take away from them.

Enlarge Image

Prashanth Vishwanathan/Bloomberg News

SUGAR: Down 14%

Indexes also can look quite different from one another, which means their returns won't be similar. This year, the iPath Dow Jones-UBS Commodity Index Total Return ETN DJP -0.56% has lost 11%, according to investment researcher Morningstar MORN -0.95% . The PowerShares DB Commodity Index Tracking Fund, which follows a different index, has lost only 6.7%.

Finally, even the cheapest exchange-traded products that track commodities are relatively expensive. The iPath ETN, for example, charges 0.75%, or $75 per $10,000 invested. The PowerShares fund has an expense ratio of 0.93%. Stock and bond index ETFs, on the other hand, can cost as little as 0.05%.

With that in mind, some investors stay away from owning physical commodities or futures contracts and instead buy shares of the companies that mine or harvest them.

Those who own an S&P 500 mutual fund already have about 14% of their portfolio in basic materials and energy companies, according to investment researcher Morningstar.

Some researchers argue that commodities still deserve a permanent place in investors' portfolios, but only a small slice. Duke University finance professor Campbell Harvey, who has researched commodities' role in a portfolio, recommends 5% to 15%.

As a long-term holding, a diversified ETF such as the Powershares DB Commodity ETF—which holds products such as oil, natural gas and gold—should work just fine.

But for investors who want to play individual commodities tactically, here is a breakdown of where precious and industrial metals, agricultural products and oil stand now and the best opportunities in each:

Agriculture

Farm commodities, from sugar to soybeans, have been in a rough patch lately.

Corn futures, for example, ended Friday at $4.76 a bushel, the lowest point since October 2010. Coffee futures are trading near four-year lows, while soybean prices are down 15% from their peak in mid-July.

That is a sharp reversal from the past few years. After farm commodity prices hit multiyear highs in 2011 and 2012, farmers world-wide increased plantings and revved up spending. Now, with farmers harvesting bumper crops, prices are well below their recent highs.

Some investors argue that prices already are due for a rebound. Global population growth has created a built-in driver for prices of staple foods like corn, wheat and soybeans. While slowing growth in emerging markets, particularly in China, has weighed on prices of commodities like copper, the appetite for food commodities is expected to continue to rise.

"I still believe there will be a lot of Chinese migrating to the cities and demand for food will be relatively strong," says Michael McDougall, a senior vice president of brokerage Newedge.

Sterling Smith, a futures specialist at Citigroup in Chicago, points to cotton as a potential buy, through a futures broker or exchange-traded product such as iPath Pure Beta Cotton CTNN 0.00% . Farmers are planting fewer acres and available global stocks are down.

But even here, there are risks. China, which has stockpiled 58% of the world's cotton, could release some of its inventories, causing prices to plummet.

Another way to invest in the agriculture sector would be by buying companies that produce and sell commodities, says Adam Sarhan, chief executive of New York-based investment firm Sarhan Capital.

Global agribusiness and food producer Bunge, BG -0.18% based in St. Louis, is involved broadly in commodities like sugar, corn, wheat and oilseeds. Mr. Sarhan likes Bunge because the company has a positive cash flow and pays a dividend, a plus for longer-term investors. The stock, which has risen 5.5% so far this year, has a price/earnings ratio of 11.4, based on expected 2013 earnings, compared with a 15.5 P/E for the rest of the market.

Oil

This year, U.S. crude oil has risen 18%, making it one of the few bright spots for commodities investors. Unlike other commodities, which are vulnerable to China's economic slowdown, oil prices are heavily driven by rising U.S. consumption.

"For every other commodity, demand from China is much more important," says Kate Warne, investment strategist at Edward Jones, a financial-services firm that oversees $712 billion in client assets.

Instead of attempting to get exposure to oil through an oil-futures ETF such as the United States Oil Fund, some strategists recommend investing in companies such as oil-field-services provider National-Oilwell Varco or oil major Chevron.

Investors also should consider buying shares of oil and gas pipeline companies, says Michael Peterson, managing director of energy research at investment bank MLV & Co.

Such companies, called master limited partnerships, are poised to benefit as booming energy production creates a need for more transportation infrastructure. They also offer tax benefits and are insulated from the ups and downs of energy prices, he says.

Some MLPs to consider include companies such as Plains All American Pipeline, Genesis Energy and Magellan Midstream Partners, which would benefit as pipeline

and logistics needs grow, says Mr. Peterson.

Dozens of mutual funds and exchange-traded products also specialize in MLPs, but those managed portfolios charge annual expenses that can exceed 1% of assets, often impair the tax advantages of owning MLPs directly and occasionally trade for considerably less than the underlying value of their holdings.

Precious Metals

The precious-metals market has been hit by a perceived policy shift by the Federal Reserve, as investors gaming a pullback from the central bank's stimulus efforts seek out higher-yielding assets like stocks.

Gold prices have plunged 22% in response, while silver's 34% loss reminded traders why it often is called the devil's metal. Some investors don't expect those trends to change any time soon.

"Inevitably, gold is going to go lower as we go from easing to more restrictive policies," says Adam Klopfenstein, a senior market strategist at Archer Financial Services.

Meanwhile, gold-mining stocks have fared even worse. The NYSE Arca Gold Bugs Index, which tracks 17 gold-mining companies, is down 45% in 2013.

Still, sifting through the rubble could uncover some bargains, says T. Rowe Price Group portfolio manager Rick de los Reyes.

"It's getting easier to separate the haves and the have-nots, the companies who have good, low-cost assets and good businesses and the ones who don't," he says.

So, while all gold miners will need to cut costs as prices fall, Mr. de los Reyes says that companies like Eldorado Gold—which is down 43% this year and has a P/E of 25.4—are likely to remain profitable and continue to pay dividends while others, like Barrick Gold and Kinross Gold, will struggle. The former is down 52% and has a P/E of 6.4; the latter is down 48% and has a P/E of 17.5. Both recently cut their dividends.

Investors also could find treasure by digging deeper into the precious-metals vaults. Palladium, which is also used in car-exhaust filters, has held up better than other precious metals as auto sales have outperformed expectations.

Here, exchange-traded funds like the ETFS Physical Palladium Shares, PALL +0.66% which charges a yearly fee of 0.75%, come in handy by removing the hassle of trading and storing the actual metal.

Industrial Metals

When pondering the future of industrial-metals prices, just look East. China accounts for about 45% of global demand for base metals like copper, zinc and nickel, and it is that country's economic growth and manufacturing activity that dictates which way prices will head in the coming months.

So far this year, China's manufacturing gauge has wavered between contraction and expansion and economic growth has slowed to 7.5% in the second quarter from 7.7% in the January to March period.

Nickel prices are down 18% this year, while copper and aluminum are off 13%, zinc is down 10%, tin is off 9.7% and lead has sunk 8%.

Even so, some see opportunity.

"If you believe the way to make money is to buy low and sell high, I would look at metals that are getting close to their cost of production," says Tom Winmill, portfolio manager at Midas Perpetual Portfolio .

Mr. Winmill says global economic growth is set to pick up pace early next year, boosting global demand for industrial metal.

As a result, he holds Southern Peru Copper in his fund because he thinks the company is well managed and pays dividends. The stock is up 1.5% this year.

Mr. Winmill also plans to look at building a holding in copper futures in September, when demand hits a seasonal lull, as prices have yet to reach their lows for the year.

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