

COMMODITY INVESTING: NO LONGER STRAIGHT UP

Bob Haber / September 22, 2011

Natural resource stocks and the commodities that underpin them have rewarded investors well for the better part of ten years. And the long-term outlook remains strong as demand for resources is expected to rise primarily driven by population growth, urbanization and industrialization in emerging markets.

As promising as the future looks, the game has changed. Sudden drops in commodity prices and volatility in natural resource stocks both this spring and summer confirm it.

Due to a confluence of macroeconomic factors – a broke Europe, a scuffling U.S. economy and rising emerging markets inflation – the price growth of commodities has become unbalanced and investing in the sector has become more complex. Here are three things you may want to consider when positioning client portfolios to take advantage of capital appreciation opportunities going forward:

The commodity matters

With the exception of the 18-to-24-month period spanning the financial crisis, the commodity price boom we've witnessed over the past decade has been unprecedented in terms of breadth.

All or most of the major commodity groups have boomed at the same time. This has led to a rising-tide-lifts-all-boats scenario with natural resource commodities and equities delivering strong, across-the-board price appreciation. Going forward, we expect fewer commodities will rise in unison, which means it will be important to be selective.

Many precious metals prices (gold, silver, palladium and platinum) continue to boom while many base metal prices (lead, tin, aluminum and copper) are well off their 2011 highs and may be heading toward a trough.

In energy markets, the price of crude oil has become anchored around the US\$85 a barrel mark, while natural gas has barely budged over the 12-month period ending August 31, 2011.

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A similar bifurcated story in agricultural commodities currently exists; corn prices have continued to move higher in 2011 while cotton prices have fallen.

Long-term opportunities will continue to reside in a number of commodities and those equities linked to them. However, there will be significant value opportunities by being in the right commodity at the right time.

The company matters

Similarly, it matters which natural resource companies you choose to own. For instance, when economic growth – particularly global growth – is slowing, it makes sense to reduce exposure to big-cap producers. Typically, these producers do not provide much bang-for-your-buck when the underlying price of crude is stagnant or falling.

One way to benefit from the long-term promise of a sector without being tethered to the commodity price is to invest in ancillary service providers such as pick-and-shovel companies. If, for example, an oil exploration company in Argentina happens to enjoy positive drill results, its shares will rise independently of the short-term price of oil.

Similarly, companies that provide the equipment and services to producers (rig owners for instance) will also be insulated from short-term commodity price moves. One way or the other, tactically getting into and out of the right company at the right time has the potential to deliver strong returns.

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The Commodity Matters Gold vs. Silver

The importance of being in the right commodity at the right time can be illustrated by the performance of the two metals over a 12-month period. If you had to choose between the two in September 2010 silver would've been the winner by a long shot delivering a 100% return.

But the situation is reversed if your investment time horizon was six months as illustrated in the second chart below. Over the shorter time period – March 15 to September 15, 2011 – the price of gold outpaced silver by about 10%.

Hi ho Silver ...



...Or Golden Opportunity



Silver — Gold —
Source: COMEX

The investment instrument matters

So what's the best way to navigate the new, unfolding natural resources landscape? ETFs that invest in commodity futures? Physical metal funds? Broad-based actively- or passively-managed natural resources funds? It depends on what you need.

Single-focus and broad-based commodity futures ETFs offer quick and easy access for investors, as they are traded and priced just like stocks. Their fees, however, tend to be high. Furthermore, because these funds are forced to use front-month commodity futures to correlate the fund's price to commodity prices, each new forward commodity contract costs more than the last.

Commodity ETFs are best used as a day trading tool because any long-term investment will underperform the price movements of the underlying commodity. Physical metal funds are better linked to the price moves of the underlying metal, but holding physical metals is administratively expensive for shareholders and no income or yield is generated—ignoring one of investors' top priorities today.

Broad-based, passively managed natural resources ETFs are great when all commodities are firing on all cylinders but may not be right for today's environment where investors should avoid being stuck in some commodities and companies at the wrong times.

That leaves actively managed natural resource funds. This may be a good choice as they offer tactical agility with more flexible investment options. Depending how actively managed natural resource funds are structured, they may also be able to invest in commodities futures and provide monthly distributions.

Capital appreciation aside, commodities also serve to reduce risk in a well-balanced portfolio because they tend to move out of sync with both stocks and bonds. That can be particularly true if inflation re-asserts itself, as equities and bonds normally suffer while the prices of most commodities rise.

Furthermore, commodities are denominated in US\$ and tend to rise in value when the greenback drops, which has been its overall direction for a few years.

In short, natural resources investing may have become more difficult to get right, but will the extra effort be worth it?

I believe it will be. The challenge lies in the trajectory. It's no longer straight up.

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Bob Haber is CEO and CIO of Boston-based Haber Trilix Advisors, LP and the portfolio manager for Canoe Financial's "Go Canada" mutual funds line up. He currently oversees more than \$1.5 billion in investments for the Calgary-based Canoe Financial, including natural resource related investments. He was a guest professor at Tufts University specializing in the U.S. Federal Reserve in 2009/2010.

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