

## Introduction

Traditional asset allocation models for investors have a balance of **equities** (ie stocks and shares), **bonds** (ie fixed interest investments) and **cash**, depending on the risk profile of the investor.

In recent years private investors have been able to follow what institutional investors have been doing for many years, and that is to also include an element of commercial property in their portfolios.

In order to reduce risk in their investment portfolios **investors are increasingly looking for other asset classes** to provide greater diversification. We are dealing here with one of these additional asset classes that is now available to private investors, that of natural resources, usually referred to as commodities. **Commodities are real assets**, and have little correlation with bond and equity indices, which makes them an attractive asset class in a portfolio.

Commodities have **already provided exceptional returns during the last five years**; witness the JPM Natural Resources Fund and the Merrill Lynch Gold & General Fund which have returned 33.6% pa and 24.6% pa compound respectively over this period.

However, even though the performance of commodities generally over the last five years has been so good, there is still a strong case for continuing to invest in the commodities sector.

## A Super Cycle?

Similar to economic cycles, **commodity cycles typically last 3 to 4 years**. Before the current cycle, which started in early 2002, the previous cycle lasted 3 years from 1999 to 2002, and before that we had a 5 year cycle from 1994 to 1999.

Going into its fifth year and still going strong, there are those who believe **the current cycle has the potential of developing into an extended commodities boom, or 'super cycle'**. A super cycle is a prolonged (decade or more) trend rise in real commodity prices driven by the urbanisation and industrialisation of a major economy.

Previous super cycles include the industrialisation in the US and Europe in the late 1800s and the post war reconstruction in Europe and subsequent Japanese economic rise from 1945 to 1975.

For at least the next 50 to 75 years, prices for many natural resources are headed up.

Professor Kenneth S Rogoff  
Professor of Economics, Harvard University  
Economic Counsellor and Director of Research  
International Monetary Fund 2001 to 2003

A super cycle in commodities is not a new phenomenon, but it is rare. It is believed that there have been six super cycles in the past 250 years – once in every generation. These are driven by structural changes in the global economy such as the European industrial revolution. The strong growth and industrialisation occurring in countries such as China and India will prove to be as significant as the events that drove previous super cycles. These factors, combined with ongoing economic growth from the US, Japan and Europe mean the long term outlook for commodities will remain strong.

Evy Hambro, manager  
BlackRock MLIF World Mining Fund/World Gold Fund

Whether the current cycle turns out to be a super cycle we can only wait and see. However, **we are not in the business of trying to predict short term market moves**. Our concern is to assist those who invest with us to **achieve their long term objectives**.

In this respect, we believe that it would be **prudent for investors to include an element of commodities** in their long term investment portfolios. How that is best achieved will depend on each investor's requirements and we comment on this under a later heading.

## What are Commodities?

Commodities are **bulk products, such as Coffee, Beef, Gold, Oil, Copper and Wheat**, to mention just a few. These are the raw materials that are economically profitable enough to be **traded on special commodity markets**. They are split into **'hard' commodities** such as Gold, Copper, Zinc etc, and **'soft' commodities** such as Cocoa, Coffee, Sugar etc.

Commodities form the first raw inputs into the business production process. **Their prices have a major influence on inflation** in the economy and thereby Government policy.

There is strong **demand for commodities from the emerging economies**, particularly those referred to as the BRIC countries, that is, Brazil, Russia, India and China. This strong demand, combined with a finite and inelastic supply **has created a bull market**.

Emerging economies **generate a disproportionate demand for natural resources**. They need hard commodities such as steel, nickel, tin and copper, for their industries and soft commodities, such as cocoa, coffee, soybeans, potatoes, wheat and barley, to feed an increasingly urban population.

Here in the West, Tony Blair has now laid down the challenge of a 'green revolution' to prevent global warming. However, while we and other European countries seek to reduce our petrol consumption, there is an increase in demand from the US and Asia Pacific.

On the other hand, **the US now devotes more than 15% of its corn production to produce ethanol**, an environmentally friendly fuel. The use of such biofuels by an increasing number of nations will give further impetus to the soft commodities sector.

## Investing in Commodities

Commodity investment can be done in a number of ways:

- A** by investing in **companies that produce commodities**. Many investors already hold shares in such companies or hold units in collective investment schemes such as unit trusts which invest all or part of the fund assets into such companies
- A** by purchasing, or selling, the commodities themselves **on the 'spot market' for immediate delivery**. This involves high transaction costs and is not a suitable method of investment for individual investors
- A** by purchasing, or selling **via the commodities exchanges for later delivery**. Most trading in commodities is done through 'futures' and 'options'. Taking positions in individual commodities is essentially speculative and should only be undertaken by professional investors who can afford to lose large sums of money if things go wrong.

It seems an obvious statement but **commodities make a return for investors if prices rise** after purchase. They generate losses if prices fall. Unlike financial assets, commodities offer no gain from interest income or dividends.

## What are Futures and Options?

These are contracts which offer the opportunity to **speculate on future price changes** without having to deal in the underlying commodity. Futures and options offer the opportunity to make money **from falling as well as rising** prices.

- A** **Commodity futures** are agreements to buy or sell commodities at a future date at a price agreed now. **Taking positions in commodity futures is extremely risky** because of the volatility of commodity prices. It should only be undertaken by sophisticated, rich investors who can withstand the potential losses that may arise from such contracts.
- A** **Commodity options** give investors **the right, but not the obligation**, to buy or sell commodities in the future.

The purchase of options is less risky than buying and selling futures. As there is no obligation on the option holder, they can choose to exercise the option, let it expire, or sell the option to a third party.

## The Traders of Commodity Futures and Options

Commercial and institutional users of commodities trade them by buying and selling commodity futures and options. For example, **a company which holds a large amount of zinc wants the value of the zinc to increase**. That company also wants to limit, if possible, any loss in value.

The company **can use the commodity markets to take an opposite position**, that is, they will make a gain if the price of zinc falls. By taking such a position in the commodity markets this will minimise the risk of financial loss from holding zinc when, and if, the price of zinc changes. **This is a form of futures trading and is referred to as 'hedging'**.

Many traders in commodity futures **have no interest in the asset itself and are simply speculators** who hope to profit from changes in the price of the futures contract.

Unlike the company who simply wish to 'hedge' their holding in a particular commodity, **a speculator does not own the underlying commodity**. His risk is all one way and speculators can lose substantial amounts of capital.

## Where are Commodities Traded?

'Soft' commodities like cocoa, coffee, sugar, potatoes, wheat and barley are traded in London on **Euronext.liffe** ([www.euronext.com](http://www.euronext.com)), formerly the London International Financial Futures and Options Exchange.

'Hard' commodities like tin and copper are traded in London at the **London Metal Exchange** ([www.lme.co.uk](http://www.lme.co.uk)).

## Past performance of Commodities

There are two main commodity indices. These are the **Goldman Sachs Commodity Index** ([www2.goldmansachs.com](http://www2.goldmansachs.com)) and the **Dow Jones AIG Commodity Index** ([www.djindexes.com](http://www.djindexes.com)), although there are a number of variations of these.

A comparison of the current weighting (April 2007) of the components of each index is as follows:

Index	Energy %	Industrial Metals %	Precious Metals %	Agriculture %	Livestock %
GSCI	69.8	11.2	2.4	11.7	4.9
DJ-AIG	33.0	18.5	9.1	30.3	9.1

Both indices are well diversified giving access to worldwide commodities from **natural gas to cocoa and zinc to lean hogs** (what we call pork bellies).

The Dow Jones AIG Commodities Index **gives a truer picture of the overall movement in the price of commodities** because there are imposed limits of a maximum of 33% for any commodity sector and the benchmark rebalances on an annual basis. This means that **the DJ-AIG index is generally less volatile than the GSCI** as it is not so affected by the oil price.

Long term performance has been comparable with equities with the Dow Jones AIG Total Return Index showing **annualised returns of 7.06% over 10 years, 14.46% over 5 years and 8.16% over 3 years** (to 30.03.2007).

### Including a Small Percentage of Commodities in a Portfolio

Despite being a very different asset classes, **much of the same rationale for investing in property applies to commodity investments**. Commodities are real assets, and have little correlation with bond and equity indices, which makes them an attractive asset class in a portfolio.

Depending on the attitude to risk of the investor, we believe that **an allocation of between 3% and 7% of an investment portfolio into commodities** is appropriate. At this level there is sufficient exposure to make an impact on the performance of the portfolio but not too much so that the overall risk of loss is increased.

However, an investment in commodities is high risk and **anyone not prepared to invest for ten years** is advised to avoid this sector altogether.

Published research into the nature of commodity returns has been produced by **Robert J Greer**, Senior Vice President and Real Return product manager at PIMCO, previously having been associated with JPMorgan Chase and Daiwa Securities as a developer and product manager of commodity indexes.

Robert Greer is recognised as the first researcher to define an index of commodities and to advocate commodities as a separate asset class. Based on data from 1970 to 2005, he **lists the following advantages of investing in an index** (ie a diverse range) of commodities:

**The total return from a commodity index is positive**, on average, and comparable in magnitude and volatility to equity returns.

Commodity index returns are **negatively correlated with stocks and bonds**. That is, they react to economic changes in the opposite way to equities and therefore reduce the risks of a portfolio.

Commodity index returns are **positively correlated with inflation**. That is, rising inflation will tend over time to produce increased returns from a commodity index. In particular, commodity index returns are positively correlated with **changes in the rate of inflation**.

Commodity prices are **not highly correlated with each other**. That is, the more diverse the types of commodities held the lower the risk from holding them.

The historical performance suggests that **a broad portfolio of commodity futures is an attractive asset class** to diversify traditional portfolios of stocks and bonds.

### Commodity Funds

There are two approaches for investors wishing to include an element of commodities in their investment portfolio:

**Commodity Funds** – Where you do not wish to disturb an existing portfolio but you like the idea of adding an element of commodities **you could invest via a specialist commodities fund**.

If this is of interest please let us know and we will be happy to recommend one or more funds to suit your particular requirements and we would generally arrange this via the Cofunds Fund Supermarket.

At the time of writing the following funds might be attractive depending on your requirements - **First State Global Resources Fund, Investec Global Energy, Investec Global Gold, JPM Natural Resources Fund, M&G Global Basics, Merrill Lynch Gold & General, Nucleus Global Gold & Resources**.

**Multi Manager Funds** – A number of multi manager funds are using a multi asset approach and this is likely to mean the inclusion of a percentage of your investment in commodities. By moving part of your investment portfolio to one or more multi asset, multi manager funds **a professional fund manager looks after the day to day running of your portfolio** and decides on how to include exposure to commodities. By using fund supermarkets we can enable you to invest as little as £1,000 in a multi manager fund.

If this is of interest please let us know and we will be happy to discuss a multi manager fund that meets your attitude to risk and other investment criteria.

At the time of writing the following multi manager providers include commodities in one or more of their portfolios – **Cazenove, HSBC, Jupiter, Neptune and New Star**.

A recent development has been the linking of a **commodity portfolio to a structured product**. Depending on the success of the first such launch which has now closed, we may see other issues in the future.

## Risk Factors

- ❑ Past performance is neither a guide to, nor a guarantee of, future returns.
- ❑ The value of your investment is not guaranteed and can go down as well as up, and you may not get back the amount you originally invested.
- ❑ The value of units in collective investment schemes that use derivatives such as options and futures may under certain circumstances be more volatile than non-derivative schemes and therefore upon withdrawal you may receive back substantially less than the full amount invested. In extreme circumstances you may receive nothing back.
- ❑ Where the portfolio invests in overseas markets, changes in currency exchange rates may mean that the value of your investment goes up or down.
- ❑ Where the portfolio invests in developing overseas markets, the arrangements in relation to regulation, dealing, liquidity and custody may be less secure than in the UK.
- ❑ The main risk of an investment in a portfolio of commodities is a significant slowdown in world economic activity which would be likely to negatively affect commodity prices.
- ❑ Soft commodities are highly dependent on the weather in the short term. Good harvests are likely to put pressure on soft commodity prices.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an investment in commodities is suitable for you, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

## For Further Info

If you would like to discuss how best to include an investment in commodities into your investment portfolio, please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**  
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Online: **www.arch-fp.co.uk**

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