Commodity Investing Primer

Every investor knows that it's too risky to put all of your eggs in one basket. Diversification is critical to any healthy investment portfolio, but even with a variety of stock holdings, you can still be impacted by broader market trends.

While traditional asset classes like stocks, bonds, and currency are generally considered safe investments, they can experience volatility due to a variety of factors, such as current geopolitical events, rising interest rates, and natural disasters. As a recent example, inflation in the U.S. has sent stock prices spiraling. The New York Times reported that the S&P 500 fell by 4% on May 18, 2022—the largest drop since June of 2020. At a time when certainty is elusive and the future is unclear, many investors are turning to less conventional assets to mitigate risks and diversify their portfolios.

What is Commodity Investing?

As investors look more and more toward alternative investments to insulate themselves from hostile market conditions, commodities trading has emerged as a leading strategy for doing so. According to Investopedia, "a commodity is a basic good used in commerce that is interchangeable with other goods of the same type." Gold and other precious metals are examples of commonly-traded commodities that are known for their price stability, especially during times of economic hardship and uncertainty.

These kinds of assets are popular among hedgers because their prices tend not to move in unison with the rest of the market, making them great tools for diversifying exposure when manufactured products are taking a beating. They are also used frequently by traders and speculators because of how liquid the commodities market is. Being highly-liquid means that they're easy to buy and sell.

Commodity investing is the practice of buying, holding, and trading these assets as you would conventional stocks and bonds. These investments behave differently than traditional assets, and many come with a potential for significant returns when traded properly. Of course, no single investment can protect you from volatility entirely. Understanding the risks and benefits associated with each type of commodity is crucial to making wise investment decisions.

Types of Commodities

Commodities are the raw goods and materials that manufacturers use to create other products. These are also known as primary economic goods, as opposed to the secondary goods that make up most of the economy. Centuries ago, the most valuable commodities where highly sought-after items like spices and silk, but as the global economy has progressed, the value of materials has shifted to more so reflect their utility. Though market prices have evolved over the years, these assets still remain popular investments for many people.

While there are countless individual commodities in which you can invest, there are two basic types: soft and hard. As the Motley Fool writes, soft commodities are grown or raised, while hard commodities are sourced from the earth and must be mined or extracted. These types can be further broken down into four categories:

Soft Commodities

- **Agriculture**: Common agricultural products include things like corn, soybeans, wheat, and rice. As this type of commodity relies on growing and harvesting crops, products in this sector are particularly affected by seasonal volatility. However, as the population rises and the supply of food remains capped, investors have many opportunities to profit from rising crop prices.

- **Animal Products**: Meat and livestock are two other common types of soft commodities. Whether you're buying live cattle or beef that's already been processed, demand is always high for meat. Animal product commodities can also include things like milk, which has surged in market value despite pandemic-related disruptions, according to the International Dairy Foods Association.

Hard Commodities

- **Base Metals**: As previously mentioned, precious metals like gold, silver, and platinum represent a handful of the most popular commodity investments. While these materials–especially gold–are widely considered safe, reliable investments, industrial metals are also a stable choice. Aluminum, copper, and zinc are common materials found around the world, but their use in countless industries means that there will continue to be a high demand for them.

- **Energy**: Energy commodities are products like gasoline, crude oil, natural gas, and coal. Historically, oil has been a reliable investment option because it's limited supply affords its producers a high degree of pricing power, which translates into consistent earnings for shareholders. However, this market is not immune to volatility. Global events, supply chain disruptions, economic downturns, production changes, and advances in green energy sources all present risks to energy prices. We saw this in 2020, when all of these factors combined to sink oil prices to about $30 per barrel.

Investing in Commodities

Now that we've established what commodities are, let's discuss how you can start investing in them. Fortunately, it's not as complex as it might seem at first glance. Generally speaking, there are four routes you can take to start investing in commodities:

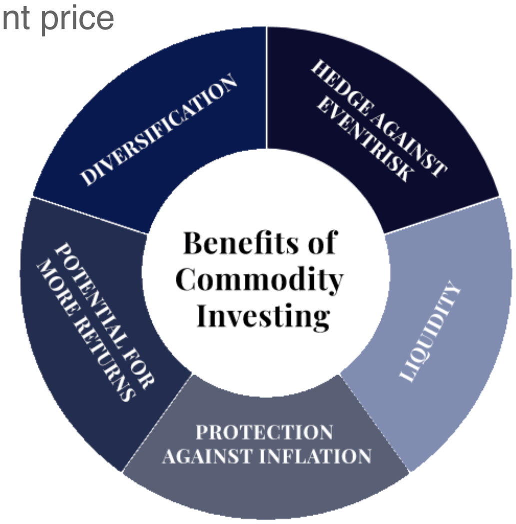
Commodity ETFs & Mutual Funds

One of the best ways to invest in commodities is through commodity exchange-traded funds (ETFs) and mutual funds. Both investment vehicles will give you diverse exposure to the commodities market through a combination of futures contracts and hard assets like metals and raw materials. When it comes to identifying an ETF or mutual fund to invest in, you can choose a general investment or one that's focused on a particular segment of the market.

Commodity Futures

If you have a brokerage account that allows for it, you can trade commodity futures contracts for a high-risk, high-reward investment. A futures contract is an agreement between two parties to exchange (buy or sell) an asset for a specified price at a specified time in the future. This makes them a useful tool for those looking to speculate on individual commodity prices or lock in arbitrage opportunities.

With that being said, this strategy may be better suited for large companies involved in commodities than for individual investors. This is because you're required to maintain a "margin" of capital in your brokerage to account for frequent price movements. If prices fall below a certain threshold, you'll receive a margin call from your broker asking for you to deposit more cash.



Stocks of Commodity Producers

For investors who don't have the option to invest in futures contracts–or don't have the willingness to assume the risk–buying shares in a company that produces commodities can be a great alternative method for earning a profit from commodities. Share prices don't always align with movements in the commodity market, which presents investors with an opportunity to acquire healthy stocks at a favorable price and then profit from their appreciation.

Physical Commodities

Perhaps the most straightforward way to invest in commodities is simply buying the physical material or goods. If you choose to go this route, it's relatively easy to find a seller that's willing to trade the commodity in which you want to invest. While this negates the need for a third party and saves you money on transaction costs, it can be difficult to handle the logistics of shipping, storing, and delivering perishable commodities.

Start Investing in Commodities

As with any investment, commodities can produce excess returns, but they also come with inherent risks. Before you start investing in commodities, it's best to discuss your goals and options with a trusted financial professional. They can help you determine the best assets for your portfolio and help you start your commodities investing journey.

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ABOUT STEVE DECESARE

Certified Financial Planner™ and President of DeCesare Retirement Specialists

One of Philadelphia's leading retirement transition specialist, Steve DeCesare, CFP®, is a second-generation financial planner who has spent the last decade of his career helping professionals transition into retirement with financial confidence.

His multi-disciplinary planning approach works to ensure that the investment, income, tax and estate strategies are in place to achieve each of his client's financial and lifestyle goals for retirement. Steve specializes in offering guidance to corporate employees regarding their company sponsored retirement plans such as 401(k)s and pensions. He also advises on rollovers to and investment decisions within Individual Retirement Accounts (IRAs). Additionally, he helps employees who are facing workplace transition with the critical decisions and financial plan adjustments that need to be made to help ensure a smooth progression of their financial life as they enter into their next job or retirement.

Steve is a CERTIFIED FINANCIAL PLANNER™ professional and Investment Advisor Representative of DeCesare Retirement Specialists a Registered Investment Advisor. He is also life and health insurance licensed in the states of New Jersey and Pennsylvania. Steve is a member of the Financial Planning Association (FPA) and a recipient of the 2012, 2013, 2014, 2015, 2016, 2017, 2018, 2019, 2020 and 2021 Five Star Wealth Manager Award. As a financial resource, Steve has been quoted in numerous media outlets including *USA Today*, *Money*, *The Washington Post, The Wall Street Journal* and *Bankrate.com*.

We invite you to call DeCesare Retirement Specialists at 856.235.3830 to schedule a no-obligation, complimentary consultation to explore options for your current financial and retirement plan.