

Commodities

Hello!

You may have noticed that references to commodities by the media have been increasing over the past few years. The two that we often hear about are gold and crude oil – over the last five years, the price of gold has increased by over 140%, and for crude oil, up by 43%. For the same time period, the S&P 500 index is down by -4% (including dividends). Commodities have become an increasingly popular investment for clients who are looking to diversify their portfolio and, therefore, reduce the overall volatility.

Definition of Commodities

Commodities are raw materials which are used to create consumer products such as food, clothing, jewelry, and gasoline. Prices are determined by demand and as a function of their market as a whole.

Commodities are classified as “real assets”, unlike equities and fixed income securities, which are “financial assets”. As a result, they tend to react to changing economic fundamentals differently from traditional financial assets.

Types of Commodities

They can be classified into five areas:

1. **Softs** – cocoa, coffee, orange juice, sugar, and cotton
2. **Energy** – crude oil, heating oil, natural gas, and gasoline
3. **Livestock** – live cattle, pork bellies, and lean hogs

4. **Precious Metals** – gold, silver, and copper

5. **Grains** – corn, soybean, wheat, oat, and rice

You can find more information on these different types of commodities in the Additional Clarity section of our website.

Demand for Commodities

With the continued global economic growth, especially in the emerging market regions such as China and India, it has resulted in significant amounts of investments into commodities (steel, oil, etc.) in order to support the development in infrastructure, housing, sewage systems and transportation. This increase in demand has led to higher commodity prices.

When you take into account that there are over 6.8 billion people in the world, and more than 70% live in undeveloped or underdeveloped areas, there will likely be continued investments into commodities to develop those areas.

Commodities as an Asset Class

Commodities are known as one of a handful of asset classes that typically benefit during periods of rising inflation. As the demand for goods and services increases, commodity prices will also. This in turn causes the prices of commodities, which are used to make those goods and services, to go up as well. Investing in commodities is often regarded as a way to hedge against inflation.

Since commodities are very different from other traditional assets, they tend to not move in the same direction during changing economic and market conditions. Given this, investing in commodities helps to further diversify one's portfolio and potentially reduce the variance of overall returns.

Even though commodities have generated superior returns in the past, they do come with more risk than most other equity investments. Despite this, having a small exposure to commodities in a portfolio helps to reduce the overall portfolio risk, especially given its low correlation to other asset classes.