SUBJECT: Questions You Were Afraid to Ask #13 – What Are the Pros and Cons of Investing in Commodities?

The only bad question is the one left unasked. That's the premise behind many of our recent emails. Each covers a different investment-related question that many people have but are afraid to ask. In our last email, we discussed what it means to invest in commodities and how regular investors actually do so. So, in this letter, let's break down:

Questions You Were Afraid to Ask #13: What are the pros and cons of investing in commodities?

As we covered in Question #12, a commodity is a **physical product** that is either consumed or used to produce something else. For example, corn, sugar, and cotton are all agricultural commodities. Pork, poultry, and cattle are livestock commodities. Oil, gas, and precious metals like gold and silver are commodities, too.

A commodity is generally seen as an **alternative investment.** Traditionally, large institutions and professional traders are the most likely to invest in commodities, but regular people can, too. Like every type of investment, though, there are both potential benefits *and* risks that come with commodities. Some of these are very specific to commodities.

First, let's look at some of the pros of investing in commodities:

Diversification. As you know, *all* types of investments will rise and fall in value at different times. That's why we recommend that your portfolio consists of diverse asset classes, each driven by different factors. (Financial advisors like us refer to this as having *low correlation,* meaning price changes in one asset don't affect the price of another asset.)

Typically, commodities have a low correlation to stocks and bonds. Every type of commodity is affected by different economic factors. Most of *those* don't usually affect, say, stocks. For example, while changing interest rates can have a major impact on stocks, they don't have a direct effect on cotton prices. And though a hurricane in the Gulf of Mexico can dramatically impact oil prices, it may not mean much to the overall stock market.

For these reasons, investing in commodities can add valuable diversification to your portfolio.

Diversification can be important because it can help cushion your portfolio from major volatility. If one asset class takes a hit, the others could help compensate. However, it is important to note that diversification doesn't eliminate risk.

Hedge Against Inflation. During periods of high inflation, the price of most consumer goods and services will go up. While that can make for an unpleasant-looking receipt at the grocery store, it can be a boon to commodity investors. That's because the price of many commodities has tended to go up with inflation. As a result, investing in commodities may help “hedge” – or lessen – the risk of investing in *other* asset classes that may be negatively affected by inflation.

Potential for Significant Returns. Commodities can also – potentially – produce meaningful returns. Certain types of commodities will occasionally rise drastically in demand, taking their price up with them. As a result, investing in the right commodity at the right time can help investors generate a significant profit!

Of course, that same potential is also behind some of the downsides to investing in commodities:

Volatility. Commodities can be extremely volatile. As you’ve no doubt seen, the price of any commodity (say, oil, or gold) can fall remarkably fast if the *demand* for those products falls far below their supply. For these reasons, you should only invest in commodities if you can afford to take on the…

Multiple Risks. As we mentioned, all types of investments come with risks. However, the risks associated with commodities are particularly large and varied. For example, some commodities – especially agricultural ones – are vulnerable to weather. Others can be affected by natural disasters, military conflicts, or changing government regulations. While these same factors can certainly drive prices *up,* they are also just as likely to drag prices *down* if the wrong conditions arise. Furthermore, investors have no control over these types of risks…and they are notoriously difficult to predict in advance.

No Income. Finally, commodities do not produce any income for investors the way bonds or dividend-paying stocks do. So, investors seeking income – especially retirees – may find that the pros of commodities are just not worth the risks when it comes to fulfilling their needs.

In the end, there’s simply no “one size fits all” type of investment, and that’s especially true of commodities. While they *can* be a viable fit for some portfolios, every investor must look carefully at whether commodities are right for their *needs*, and whether the risks associated with them are more than they can afford.

So, now you know the “how” *and* the “why” of investing in commodities. In our next few emails, we are going to demystify common investment–related jargon you may hear bandied about by the media. In the meantime, have a great month!

Sincerely,

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Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Alternative investments, such as hedge funds, funds of hedge funds, managed futures, private capital, real assets and real estate funds, are not appropriate for all investors. They are speculative, highly illiquid, and are designed for long-term investment, and not as trading vehicle. These funds carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. The high expenses associated with alternative investments must be offset by trading profits and other income which may not be realized. Unlike mutual funds, alternative investments are not subject to some of the regulations designed to protect investors and are not required to provide the same level of disclosure as would be received from a mutual fund. They trade in diverse complex strategies that are affected in different ways and at different times by changing market conditions. Strategies may, at times, be out of market favor for considerable periods with adverse consequences for the fund and the investor. An investment in these funds involve the risks inherent in an investment in securities and can include losses associated with speculative investment practices, including hedging and leveraging through derivatives, such as futures, options, swaps, short selling, investments in non-U.S. securities, “junk” bonds and illiquid investments. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. At times, a fund may be unable to sell certain of its illiquid investments without a substantial drop in price, if at all. Other risks can include those associated with potential lack of diversification, restrictions on transferring interests, no available secondary market, complex tax structures, delays in tax reporting, valuation of securities and pricing. An investment in a fund of funds carries additional risks including asset-based fees and expenses at the fund level and indirect fees, expenses and asset-based compensation of investment funds in which these funds invest. An investor should review the private placement memorandum, subscription agreement and other related offering materials for complete information regarding terms, including all applicable fees, as well as the specific risks associated with a fund before investing.

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