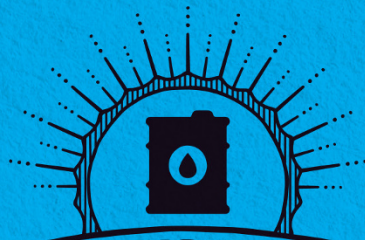


LEARNING MADE EASY



INVESTING

IN

COMMODITIES

SECOND EDITION

AMINE BOUCHENOUF

for
dummies[®]
A Wiley Brand



Investing in Commodities

Second Edition

by Amine Bouchentouf

for
dummies[®]
A Wiley Brand

Investing in Commodities For Dummies®, Second Edition

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Introduction

In the last two decades, commodities have grown into their own legitimate and respected asset class. Trade magazines and financial newsletters frequently include feature-length articles on the topic. Financial TV stations regularly report oil, gold, and copper prices on the crawling ticker. And no global macro money manager can claim continued success without constantly keeping a pulse on commodities.

Why are commodities, long regarded as an inferior asset class, quickly moving to the investing mainstream? Good performance. Investors like to reward good performance, and commodities have performed well in recent years. In addition, investors can more easily access these markets: Plenty of new investment vehicles, from exchange-traded funds (ETFs) to master limited partnerships (MLPs), have been introduced to satisfy investor demand.

Commodities are a complex asset class, with many different types of assets and many different vehicles through which to invest. As commodities have been generating more interest, there's a large demand for a product to help average investors get a grip on the market fundamentals. Commodities as an asset class have been plagued by a lot of misinformation, and it's sometimes difficult to separate fact from fiction or outright fantasy. The aim of this book is to help you figure out what commodities are all about and, more important, develop an intelligent investment strategy to profit in this market.

Keep in mind that disruptions are part of the market process. Investors who protect themselves through a "margin of safety" philosophy will be able to weather periods of extreme volatility. Using this book, you'll better equip yourself to avoid the pitfalls inherent in any investment activity.

About This Book

My aim in writing this book is to offer you a comprehensive guide to the commodities markets and show you a number of investment strategies to help you profit in them. You don't have to invest in just crude oil or gold futures contracts to benefit. You

can trade ETFs, invest in companies that process commodities such as uranium, buy precious metals ownership certificates, or invest in MLPs. The commodities markets are global in nature, and so are the investment opportunities. My goal is to help you uncover these global opportunities and offer you investment ideas and tools to unlock and unleash the power of the commodities markets. Best of all, I do all of this in plain English!

Anyone who's been around commodities, even for a short period of time, realizes that folks in the business are prone to engage in linguistic acrobatics. Words like *molybdenum*, *backwardation*, and *contango* are thrown around like "hello" and "thank you." Sometimes these words seem intimidating and confusing. Don't be intimidated. Language is powerful, after all, and getting a grip on the concepts behind the words is critical, especially if you want to come out ahead in the markets. That's why I use everyday language to explain even the most abstract and arcane concepts.

Information that's interesting but not essential to understanding commodities is tucked into shaded sidebars. But if any technicalities make it into the main text, I give you a heads-up with a Technical Stuff icon. That's where you can skip over or speed read.

Keep in mind that when this book was printed, some web addresses may have needed to break across two lines of text. Wherever that's the case, rest assured that this book uses no any extra characters to indicate the break. So, when going to one of these web addresses, just type in exactly what you see in this book. Pretend that the line break doesn't exist.

Foolish Assumptions

In writing this book, I made the following assumptions about you:

- » You have some previous investing experience but are looking to diversify your holdings.
- » You're familiar with commodities trading, but you want to brush up on your knowledge.
- » Your traditional investments (stocks, bonds, mutual funds) haven't performed according to your expectations, and you're looking for alternatives to maximize your returns.

- » You're a new investor or someone with minimal trading experience, and you're interested in a broad-based investment approach that includes commodities and other assets.
- » You understand the attractiveness of commodities and want a comprehensive and easy-to-use guide to help you get started.
- » You're skeptical about the benefits of commodities, but you want to read about them anyway. Please do — I'm confident that this book will change your mind!
- » You have little or no investment experience but are eager to find out more about investing. This book not only explores investing in commodities, but also includes explanations of general investing guidelines that apply to any market.

Icons Used in This Book

One of the pleasures of writing a *For Dummies* book is that you get to use all sorts of fun, interactive tools to highlight or illustrate a point. Here are some icons that I use throughout this book.



REMEMBER

I use the Remember icon to highlight information that you want to keep in mind or that's referenced in other parts of the book.



TIP

When you see the Tip icon, make sure that you read the accompanying text carefully. It includes information, analysis, or insight that will help you successfully implement an investment strategy.



TECHNICAL
STUFF

I explain more technical information with the Technical Stuff icon. The commodities markets are complex, and the vocabulary and concepts are quite tricky. You can skip these paragraphs if you just want a quick overview of the commodities world, but be sure to read them before seriously investing. They give you a better grasp of the concepts discussed.



WARNING

Investing can be an extremely rewarding enterprise, but it can also be a hazardous endeavor if you're not careful. I use the Warning icon to warn you of potential pitfalls. Stay alert for these icons because they contain information that may help you avoid losing money.

Where to Go from Here

I've organized this book in a way that gives you the most accurate and relevant information related to investing in general and commodity investing in particular. The book is modular in nature, meaning that although it reads like a book from start to finish, you can read one chapter or even a section at a time without needing to read the whole book to understand the topic that's discussed.

If you're a true beginner, however, I recommend that you read Part 1 carefully before you start skipping around in the chapters on particular commodities.

1

**Getting
Started with
Commodities**

IN THIS PART . . .

Know why you should invest in commodities, check out the commodities markets, and find the best ways to invest in commodities.

Celebrate the advantages, acknowledge the downsides, and manage risk when investing in commodities.

- » Defining the commodities markets
- » Determining the best ways to trade commodities
- » Identifying the major commodities

Chapter **1**

Investors, Start Your Engines! The Basics of Commodities

The commodities markets are broad and deep, presenting both challenges and opportunities. Investors are often overwhelmed simply by the number of commodities out there: more than 30 tradable commodities to choose from. How do you decide whether to trade crude oil or gold, sugar or palladium, natural gas or frozen concentrated orange juice, soybeans or aluminum? What about corn, feeder cattle, and silver? Should you trade these commodities as well? And, if you do, what's the best way to invest in them? Should you go through the futures markets, go through the equity markets, or buy the physical stuff (such as silver coins or gold bullion)? And do all commodities move in tandem, or do they perform independently of each other?

With so many variables to keep track of and options to choose from, just getting started in commodities can be daunting. But have no fear — this book provides you with the actionable information, knowledge, insight, and analysis to help you grab the commodities market by the horns. Maybe you've heard a lot of

myths and fantasies about commodities. I shatter some of these myths and, in the process, clear the way to help you identify the real moneymaking opportunities.

The commodities universe is large, and investment opportunities abound. In this book, I help you explore this world inside and out. By exploring this fascinating universe, not only do you get insight into the world's most crucial commodities — and catch a glimpse of how the global capital markets operate — but you also find out how to capitalize on this information to generate profits.

Defining Commodities and Their Investment Characteristics



REMEMBER

Just what exactly are commodities? Put simply, commodities are the raw materials humans use to create a livable world. Humans have been exploiting earth's natural resources since the beginning of time. They use agricultural products to feed themselves, metals to build weapons and tools, and energy to sustain themselves. Energy, metals, and agricultural products are the three classes of commodities and the essential building blocks of the global economy.

For the purposes of this book, I present commodities that fit a very specific definition, which I define in the following list. For example, the commodities I present must be raw materials. I don't discuss currencies — even though they trade in the futures markets — because they're not raw materials; they can't be physically used to build anything. In addition, the commodities must present real moneymaking opportunities to investors.



REMEMBER

All the commodities I cover in this book meet the following criteria:

- » **Tradability:** The commodity has to be tradable, meaning that there needs to be a viable investment vehicle to help you trade it. For example, I include a commodity if it has a futures contract assigned to it on one of the major exchanges, if a company processes it, or if an exchange-traded fund (ETF) tracks it. Uranium, which is an important energy commodity, isn't tracked by a futures contract, but

several companies specialize in mining and processing this mineral; by investing in these companies, you get exposure to uranium.

» **Deliverability:** All the commodities have to be physically deliverable. I include crude oil because it can be delivered in barrels, and I include wheat because it can be delivered by the bushel. However, I don't include currencies, interest rates, and other financial futures contracts because they're not physical commodities.

COMMODITIES THROUGHOUT HISTORY

History reveals that the most devastating battles have been fought over crude oil, gold, uranium, and other precious natural resources (all covered in this book). When Francisco Pizarro's first expedition to South America in 1524 led him to the discovery of vast amounts of gold deposits, his conquistadors proceeded to wipe out the whole Inca civilization that stood between them and the gold. As a matter of fact, it's probably unlikely that Christopher Columbus would have come across to the North American continent in the first place were it not for an unquenchable desire to find the shortest and most secure route to transport spices and other commodities from India to Europe.

At the end of the 19th century, this continuous quest for commodities resulted in the deadly South African Boer Wars, which pitted the British Empire's armed forces against local fighters in a bloody battle over South Africa's precious metals and minerals. The 20th century, which heralded a new historical phase — the Hydrocarbon Age, shortly followed by the Nuclear Age — marks a turning point in humans' ability to utilize and exploit the earth's raw materials and the extent to which they will go to preserve this control. The Persian Gulf War of 1991, which, at its essence, was an effort to stabilize global oil markets after the Iraqi invasion of oil-rich Kuwait in the Middle East, is another manifestation of this historical reality.

To this day, international players in the geopolitical world consider access to the world's vast deposits of oil, gold, copper, and other resources. Commodities have, thus, determined the fate and wealth of nations throughout history and will continue to do so in the future.

» **Liquidity:** I don't include any commodities that trade in illiquid markets. Every commodity in this book has an active market, with buyers and sellers constantly transacting with each other. Liquidity is critical because it gives you the option of getting in and out of an investment without having to face the difficulty of trying to find a buyer or seller for your securities.

Going for a Spin: Choosing the Right Investment Vehicle

The two most critical questions to ask yourself before getting started in commodities are the following: What commodity should I invest in? How do I invest in it? I answer the second question first and then examine which commodities to choose.

The futures markets

In the futures markets, individuals, institutions, and sometimes governments transact with each other for price-hedging and speculating purposes. An airline company, for instance, may want to use futures to enter into an agreement with a fuel company to buy a fixed amount of jet fuel for a fixed price for a fixed period of time. This transaction in the futures markets allows the airline to hedge against the volatility associated with the price of jet fuel. Although commercial users are the main players in the futures arena, traders and investors also use the futures market to profit from price volatility through various trading techniques.



TECHNICAL
STUFF

One such trading technique is *arbitrage*, which takes advantage of price discrepancies between different futures markets. For example, in an arbitrage trade, you purchase and sell the crude oil futures contract simultaneously in different trading venues, for the purpose of capturing price discrepancies between these venues. I take a look at some arbitrage opportunities in Chapter 13.



REMEMBER

The futures markets are administered by the various commodity exchanges, such as the Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE). Investing through the futures markets requires a good understanding of futures contracts, options on futures, forwards, spreads, and other derivative products. I examine these products in depth in Chapter 13.

The most direct way of investing in the futures markets is to open an account with a *futures commission merchant* (FCM). The FCM is much like a traditional stock brokerage house (such as Schwab, Fidelity, or Merrill Lynch) except that it's allowed to offer products that trade on the futures markets. Here are some other ways to get involved in futures:

- » **Commodity trading advisor (CTA):** The CTA is an individual or company licensed to trade futures contracts on your behalf.
- » **Commodity pool operator (CPO):** CPOs are similar to CTAs, except CPOs can manage the funds of multiple clients under one account. This pooling provides additional leverage when trading futures.
- » **Commodity indexes:** A commodity index is a benchmark, similar to the Dow Jones Industrial Average or the S&P 500, that tracks a basket of the most liquid commodities. You can track the performance of a commodity index, which allows you to essentially "buy the market." A number of commodity indexes are available, including the Goldman Sachs Commodity Index and the Reuters/Jefferies CRB Index, which I cover in Chapter 12.

These examples are only a few ways to access the futures markets. Be sure to read Chapter 12 for additional methods.

A number of organizations regulate the futures markets, including the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). These organizations monitor the markets to prevent market fraud and manipulation and to protect investors from such activity.



WARNING

Trading futures isn't for everyone. By their very nature, futures markets, contracts, and products are extremely complex and require a great deal of mastery by even the most seasoned investors. If you don't feel that you have a good handle on all the concepts involved in trading futures, don't jump into them; you could lose a lot more than your principal because of the use of leverage and other characteristics unique to the futures markets. If you're not comfortable trading futures, don't sweat it. You can invest in commodities in multiple other ways.

The equity markets

Although the futures markets offer the most direct investment gateway to the commodities markets, the equity markets also offer access to these raw materials. You can invest in companies that specialize in the production, transformation, and distribution of these natural resources. If you're a stock investor familiar with the equity markets, this may be a good route for you to access the commodities markets.

The only drawback of the equity markets is that you have to consider external factors, such as management competence, tax situation, debt levels, and profit margins, which have nothing to do with the underlying commodity. That said, investing in companies that process commodities still allows you to profit from the commodities boom.

Publicly traded companies

The size, structure, and scope of the companies involved in the business are varied, and I cover most of these companies throughout this book. I offer a description of the company, including a snapshot of its financial situation, future growth prospects, and areas of operation. I then make a recommendation based on the market fundamentals of the company.

You encounter the following types of companies in this book:

- » **Diversified mining companies:** A number of companies focus exclusively on mining metals and minerals. Some of these companies, such as Anglo-American PLC (Nasdaq: AAUK) and BHP Billiton (NYSE: BHP), have operations across the spectrum of the metals complex, mining metals that range from gold to zinc. I look at these companies in Chapter 9.
- » **Electric utilities:** Utilities are an integral part of modern life because they provide one of life's most essential necessities: electricity. They're also a good investment because they've historically offered large dividends to shareholders. Read Chapter 5 to figure out whether these companies are right for you.

» **Integrated energy companies:** These companies, such as ExxonMobil (NYSE: XOM) and Chevron (NYSE: CVX), are involved in all aspects of the energy industry, from the extraction of crude oil to the distribution of liquefied natural gas (LNG). They give you broad exposure to the energy complex (see Chapter 6).

This list is only a sampling of the commodity companies I cover in this book. I also analyze highly specialized companies, such as coal-mining companies (Chapter 5), oil refiners (Chapter 6), platinum-mining companies (Chapter 7), and purveyors of gourmet coffee products (Chapter 10).

Master limited partnerships

Master limited partnerships (MLPs) invest in energy infrastructure such as oil pipelines and natural gas storage facilities. I'm a big fan of MLPs because they're a *publicly traded partnership*. They offer the benefit of trading like a corporation on a public exchange, while offering the tax advantages of a private partnership. MLPs are required to transfer all cash flow back to shareholders, which makes them an attractive investment. I dissect the structure of MLPs in Chapter 14 and introduce you to some of the biggest names in the business so you can take advantage of this unique investment.

Managed funds

Sometimes it's just easier to have someone else manage your investments for you. Luckily, you can count on professional money managers who specialize in commodity trading to handle your investments.

Consider a few of these options:

» **ETFs:** ETFs are an increasingly popular investment because they're managed funds that offer the convenience of trading like stocks. In recent years, ETFs have appeared to track everything from crude oil and gold to diversified commodity indexes. Find out how to benefit from these vehicles in Chapter 12.

» **Mutual funds:** If you've previously invested in mutual funds and you're comfortable with them, look into adding a mutual fund that gives you exposure to the commodities markets.

A number of funds are available that invest solely in commodities. I examine these commodity mutual funds in Chapter 14.



TIP

If you have a pet or a child, sometimes you hire someone to look after them. Before you hire this individual, you interview candidates, check their references, and examine their previous experience. When you're satisfied with the top candidate's competency, only then do you entrust that person with the responsibility of looking after your pet, child, or both. The same thing applies when you're shopping for a money manager. If you already have a money manager you trust and are happy with, stick with them. If you're looking for a new investment professional to look after your investments, you need to investigate that person as thoroughly as possible. In Chapter 14, I examine the selection criteria to use when shopping for a money manager.

Physical commodity purchases

The most direct way of investing in certain commodities is to actually buy them outright. Precious metals such as gold, silver, and platinum are great examples of this. Because the price of gold and silver has skyrocketed recently, you may have seen ads on TV or in newspapers from companies offering to buy your gold or silver jewelry. As gold and silver prices increase in the futures markets, they also cause prices in the spot markets to rise (and vice versa). You can cash in on this trend by buying coins, bullion, or even jewelry. I present this unique investment strategy in Chapter 7.



REMEMBER

This investment strategy is suitable for a limited number of commodities, mostly precious metals like gold, silver, and platinum. Unless you own a farm, keeping live cattle or feeder cattle to profit from price increases doesn't make much sense. And I won't even mention commodities like crude oil or uranium!

Checking Out What's on the Menu

I cover a number of commodities in this book. Here's a list of all the commodities you can expect to encounter while reading this book.

Energy

Energy has always been indispensable for human survival and makes for a great investment. Energy, whether fossil fuels or renewable energy sources, has attracted a lot of attention from investors as they seek to profit from the world's seemingly unquenchable thirst for energy. In this book, I present all the major forms of energy, from crude oil and coal to electricity and solar power, and show you how to profit in this arena.

- » **Crude oil:** Crude oil is the undisputed heavyweight champion in the commodities world. More barrels of crude oil are traded every single day (87 million and growing) than any other commodity. Accounting for 40 percent of total global energy consumption, crude oil provides some terrific investment opportunities.
- » **Natural gas:** Natural gas, the gaseous fossil fuel, is often overshadowed by crude oil. Nevertheless, it's a major commodity in its own right, used for everything from cooking food to heating houses during the winter. I also take a look at the prospects of LNG.
- » **Coal:** Coal accounts for more than 20 percent of total world energy consumption. In the United States, the largest energy market, 50 percent of electricity is generated through coal. Because of abundant supply, coal is making a resurgence.
- » **Uranium/nuclear power:** Because of improved environmental standards within the industry, nuclear power use is on the rise. I show you how to develop an investment strategy to capitalize on this trend.
- » **Electricity:** Electricity is a necessity of modern life, and the companies responsible for generating this special commodity have some unique characteristics. I examine how to start trading this electrifying commodity.
- » **Solar power:** For a number of reasons that range from environmental to geopolitical, demand for renewable energy sources such as solar power is increasing.
- » **Wind power:** Wind power is getting a lot of attention from investors as a viable alternative source of energy.
- » **Ethanol:** Ethanol, which is produced primarily from corn or sugar, is an increasingly popular fuel additive that offers investment potential.