

# 17 Commodity ETFs to Help Hedge Your Portfolio



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Americans are being hit by rising inflation and the subsequent explosion in commodity prices where it hurts most—at gas stations and grocery stores. Right alongside this growth have been the opportunities available to investors to hedge these rising prices by way of exchange traded funds (ETFs).

A barrel of oil now sells for \$133, which means you're paying around \$3.80 for a gallon of gas. That gallon of milk you bought for \$3.87 a few days ago sold for \$3.20 in 2006; and the price for a dozen eggs rose from \$1.45 to \$2.18 over the same time.

You name the commodity, if the world consumes it or relies on it to keep the gargantuan global economic wheels turning, it probably costs more today than it did yesterday. It may cost even more tomorrow. Take a look at the price of oil and gold over the past year:





## ETFs Take the Mystery Out of Commodity Investing

As you can see, commodities across the board have been increasing in price as supply struggles to keep up with growing global demand. We may be shoveling out more and more money to pay for life's essentials, but there's no reason investors that shouldn't have the opportunity to profit from and hedge these price spikes, too.



Thanks to a growing wave of commodities exchange traded funds (ETFs), investors now have many options for participating in the current commodities bull market.

This hasn't always been the case, however.

Before the influx of ETFs, most individual investors were simply left out in the cold.

For decades, commodities remained the exclusive domain of professional traders, large companies and hedge funds—and for good reason.

Futures trading requires an in-depth understanding of economic trends and the ability to anticipate the impact those trends will have on the cost of goods, as well as the willingness to monitor trading activity on a daily basis.

It's not for the faint-of-heart.

Risk and reward are high, but prior to commodities ETFs, you had to know the "game" intimately.

Now, investors have the most simple and diversified tool at their disposal to access commodities.

Understanding futures contracts and their intricacies isn't a prerequisite for diving in - the fund takes care of that for you. However, there are still things investors need to know. Commodity ETFs come in various shapes and sizes, from gold to soybeans to cattle. Some hold futures;

others hold stock in companies involved in the making of commodities. Here's an explanation of each:



- **Physical Commodities:** The most direct way to own a commodity is to actually buy the commodity. But the hassle of buying, storing and selling gold is not very practical. So, you can buy an ETF that buys gold, and your shares give you partial ownership of the physical metal.
- **Individual Commodity Futures:** The main factor determining the performance of an ETF linked to commodity futures is changes in the spot price of the underlying commodity. The "spot" price is the current price of the commodity and as it changes, so does the value of the future contracts based on it. If the spot price goes up, the value of the futures contracts goes up, and so does the value of a share of an ETF holding these futures. One aspect to keep in mind with respect to this type of ETF: Any gains or losses generated throughout the year within the fund are taxed as 60% long-term and 40% short-term gains, regardless of how long the contracts were held. At current rates, this works out to a maximum 23% capital gains rate; higher than stocks but lower than collectibles.
- **Commodity Indexes:** ETFs linked to commodity indexes give investors the ability to diversify their holdings. For example, you can invest in a broad-based ETF to give you plays on individual commodities such as soybeans, corn, sugar and wheat; or you can buy an ETF that gives you pieces of agriculture, energy and metals.
- **Commodity Equities:** Finally, ETFs linked to commodity equities are those that hold a basket of companies that make or process a commodity. These have a different risk/return profile than commodities futures alone. They expose the investor to company risk in addition to issues related to the specific commodity. This can be good or bad. Investors have the additional upside of appreciation in individual company stocks, but prices of company stock also can go down in response to company-specific events.

Now that you know the inner workings of commodity ETFs, let's dig into the nitty-gritty: the actual commodities, what's making them tick and which ETFs are available to investors.

## Agriculture

Costs for energy and land, the two biggest factors for affecting agricultural pricing, have risen sharply in the past several years.



More than 6 billion people roam the planet right now, and on continents such as Africa, millions of people are already starving. Hoarding of one of the most basic food substances—rice—is even becoming commonplace in many areas of the world.

By 2020, it is expected that there will be 3 billion additional people in the world. This means we're essentially going to have to figure out how to double global agriculture production over the next 13 years, just to meet the population growth of the world.

Many politicians, economists and academics blame growing middle classes in China and India for slowly adopting more Western diets (which is probably just a nicer way of saying "burgers, fries and milkshakes").

The average American eats 3,770 calories a day. It's the highest caloric intake in the world. India consumes 2,440 a day per capita.



Turning to the link between agriculture and energy...ethanol, made from corn and to a lesser extent, sugar, continues to be the government's "alternative energy source of choice."

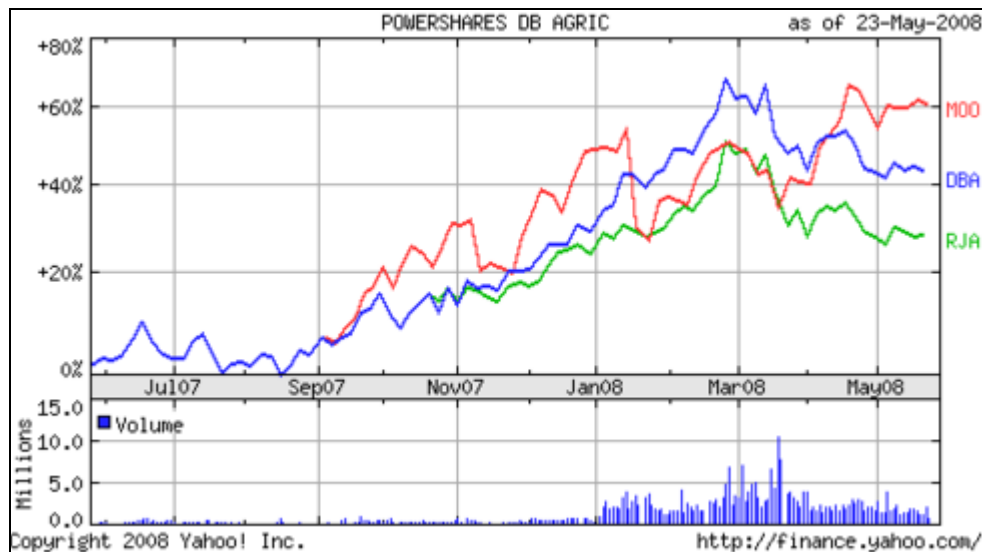
So, the agriculture community continues to promote it as a way to decrease U.S. dependence on foreign oil. The United States and other countries have set aggressive goals for ethanol production; this will result in higher demand for agricultural products, especially corn.

Many of the agricultural commodities have been on futures exchanges since the dawn of time and are some of the most active markets to trade.

Commodities in this category include both raw and processed goods. Some of the agricultural commodities most in demand are: Corn, soybeans, wheat, coffee, cocoa, sugar, cotton, cattle and hogs.

### Agricultural ETFs/ETNs to Consider

- **PowerShares DB Agriculture (DBA)** is an ETF that contracts on some of the most liquid and widely traded agricultural commodities - corn, wheat, soybeans and sugar.
- **Market Vectors Global Agribusiness (MOO)** tracks the stock-based DAXglobal Agribusiness Index and provides exposure to 40 worldwide companies in five segments: agricultural chemicals, agriproduct operations, agricultural equipment, livestock operations and ethanol/biodiesel production. The top five components, by market weight, include: Mosaic Co. (MOS), Potash Corp. (POT), Monsanto Corp. (MON), Deere & Co. (DE) and Archer-Daniels-Midland (ADM).
- **ELEMENTS Rogers International Commodity Agriculture ETN (RJA)** seeks to replicate an index that represents the value of 20 agricultural commodity futures contracts.



**Editor's Note:** *The difference between an exchange traded note (ETN) and an ETF is the structure. ETNs are issued as a senior bank note and ETFs represent a stake in an underlying commodity. ETNs possess credit risk, however, they do not have a tracking risk, unlike ETFs where there is a possibility the returns will differ from the underlying index.*

## Energy

Energy commodities not only fuel the growth of world economies, they also directly affect our daily lives via increased gas, heating and electrical prices. Because the demand for energy resources is expected to continue to grow as supplies of traditional fuels dwindle, costs will likely climb further.



After all, oil is the lifeblood of the global economy. Almost every product bought and sold is dependent on the availability of this resource—if not to make it, then most certainly to transport it.

As China, India and other emerging economies continue to build thousands of factories and as their massive populations become more affluent consumers, energy demands will increase exponentially.

In today's world, energy is provided mainly by oil and gas, both natural resources that have a finite supply. The supply of oil and thus its price is affected by a number of events. Among them are world unrest, the political climate and weather events such as hurricanes, to name just a few.

Currently, the high costs of generating and delivering alternative fuels translates into ever-increasing profits for oil companies. That will not always be the case; energy alternatives for oil from renewable resources to technology-driven resources such as clean coal and nuclear fission will change the energy market profile. But energy always will be needed. But trying to profit from energy can be challenging and complex. Many investors already invest in the sector by owning stock of the biggest oil companies, while others dive right into the commodities market and trade futures contracts.

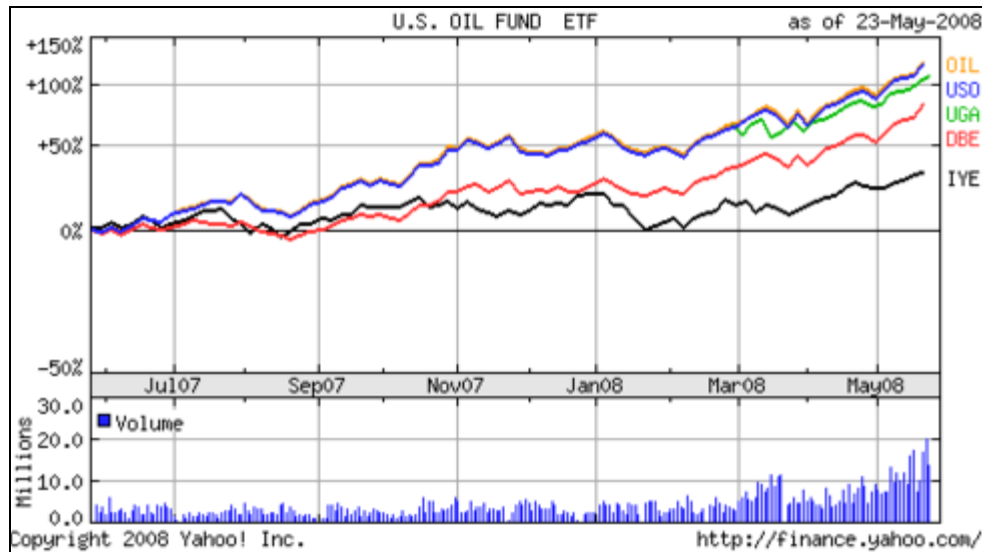
However, corrections in this sector can be brutal. In mid-2006, oil prices plunged 17.2% in just 25 trading days, or an average daily decline of 0.7%. There were five major corrections before that one, with declines averaging 18.5% over an average span of 33 trading days.

Before you decide to get into the energy sector, look at the fundamentals and not this recent run into record-breaking territory.

### Energy ETFs To Consider

- If you want a pure play on oil, the **United States Oil Fund (USO)** tracks the futures prices of West Texas Intermediate light, sweet crude oil.
- For a more diversified energy play, the **PowerShares DB Energy Fund (DBE)** replicates an index tracking the prices of two different grades of crude oil, heating oil, gasoline and natural gas.
- **United States Gasoline (UGA)** tries to match the percentage increase in the unleaded gasoline futures that trade on the New York Mercantile Exchange. In concept, this fund increases in value by the same amount that gas rises in price at the pump.

- iShares Dow Jones U.S. Energy Sector Index Fund (IYE) is as pure a play on energy as you can get with 10 top holdings including: Chevron (CVX), ConocoPhillips (COP), Exxon Mobil (XOM) and Transocean (RIG).
- iPath S&P GSCI Crude Oil Total Return Index ETN (OIL) is an unleveraged path to investment in Nymex West Texas intermediate crude oil futures. It takes a fixed-weight approach to determining asset allocation of its portfolio.



## Metals (Precious & Base)

Metals include: copper, gold, platinum, palladium, silver and steel. They are used for industrial purposes, in construction, and for jewelry. Geopolitical and economic factors in the dominant producing (South Africa, the United States and Australia) and consuming (India and the United States) countries affect the price action for metals, but each type also has its own unique fundamental influences.

In the copper market, for instance, building construction is the largest demand source.



Copper is also used for electrical and electronic products, transportation and industrial machinery manufacturing. So housing is often the best indicator for the price of copper.

In another example, gold has long been used as a hedge against political and economic uncertainties, and many central banks back their currency with gold reserves. Gold is the metal that is seen as a “safe haven” in times of world turmoil, prompting some investors to buy gold bricks, which always will have some value. Gold and copper are also used widely in industries, including computers and telecommunications.

Although gold seems to dominate the headlines, another metal—silver—has surged 150% since 2005, although its current price of \$17.92 pales in comparison to its record of \$48.70, reached on Jan. 17, 1980. Last year, industrial demand for silver jumped 7.2% to a record of 455.3 million ounces, as a result of its increased uses in batteries, superconductors and other electronic components.

Describing something as "steely" is usually a synonym for "coldness," but the steel industry is certainly heating up. In China, the number of steel factories has doubled in the last few years. Even on our home turf, steel demand is up about 30% ahead of its supply.

In the Middle East, the steel industry is said to be undergoing a transformation. It currently accounts for only 2% of the global steel trade. In 2006, the region produced 21.1 million tons of raw steel and consumed 41.6 million tons of finished goods. Those numbers are respectively forecast to rise to 35 million and 60 million tons by 2010.

### Metal ETFs to Consider

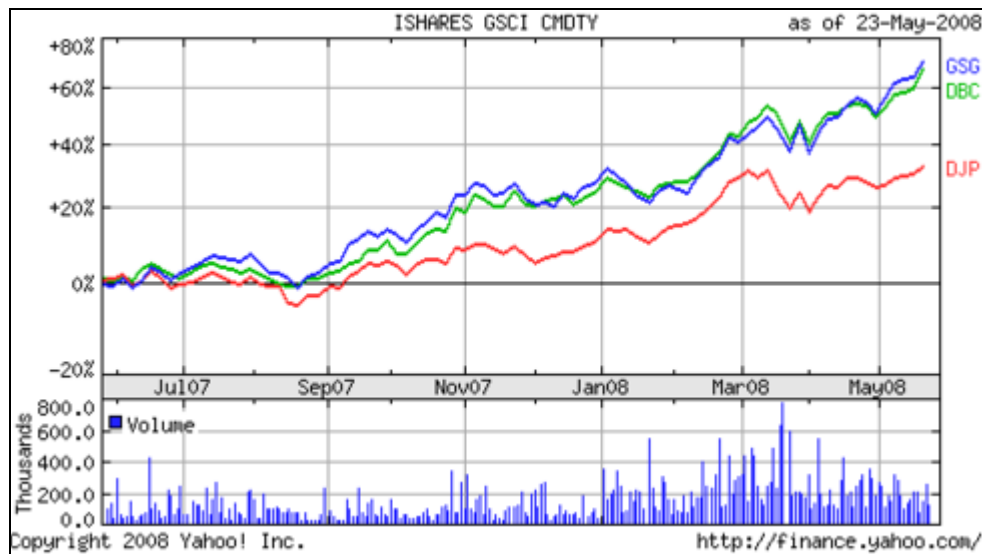
- The SPDR Gold Shares Fund (GLD) and iShares COMEX Gold Trust (IAU) hold gold bullion.
- The PowerShares DB Gold Fund (DGL) is based on the Deutsche Bank Liquid Commodity Index and is composed of futures contracts on gold and is intended to reflect the performance of the yellow metal.
- Market Vectors Steel (SLX), which launched in October 2006, holds companies involved in the production of steel. Among the top holdings are Rio Tinto (RTP), Arcelor Mittal (MT.AS) and Companhia Vale ADS (RIO).
- The iShares Silver Trust (SLV) holds silver bullion. This ETF increased its silver holdings by 11.7% since the metal's March peak, reflecting investor demand.
- PowerShares DB Base Metals (DBB) is based on an index composed of futures contracts on some of the most liquid and widely used base metals - aluminum, zinc and copper (grade A).



### Broad-Based Commodity ETFs

You might want to buy a smorgasbord of commodities rather than focus on a specific sector. It's a good way to keep the number of commodity ETFs in your portfolio to a minimum. Plus, it provides tremendous diversification. You can accomplish this with:

- iShares S&P GSCI Commodity Indexed Trust (GSG) tracks a broad index of 24 commodities weighted according to the proportion of the commodity flowing through the economy. Almost half of the index reflects crude oil, and the balance is split between other energy products such as natural gas as well as agricultural commodities, industrial and precious metals, and livestock.
- An even more diversified commodity play is the iPath Dow Jones-AIG Commodity Index Fund ETN (DJP), which tracks an index that comprises 30% energy, 30% agricultural, 20% industrial metals, 10% livestock and 10% precious metals.
- PowerShares DB Commodity Index Tracking Fund (DBC) tracks the futures for a simplified index of just six commodities: corn, crude oil, gold, heating oil, aluminum and wheat.



## Commodities: A Valuable Part of Your Portfolio

The greatest benefit of adding commodities to your portfolio is that while the value of commodities rise and fall in response to the same economic, social, political, or environmental forces as do stocks, they have a tendency to move in opposite directions.



So, it's no surprise that commodities have outpaced stocks and bonds this year. The UBS Bloomberg Constant Maturity Commodity Index of 26 commodities has returned 20% thus far in 2008. Meanwhile, the S&P 500 Index of stocks has fallen 7.3%. U.S. Treasuries have returned only 3% to investors.

The forces that propel the stock market upward sometimes have the effect of depressing the commodities markets, and vice versa. Discovering a vast, easily extractable and transportable oil reserve can drive down the cost of crude oil, but will fuel a positive response on Wall Street.

Similarly, a hurricane that forces oil rigs to shut down will have a negative impact on the stock market, while driving up the cost of oil, which has a positive impact on commodities markets.

Unlike stocks, which can lose value and even be removed from trading for non-performance, leaving investors to take the loss, commodities always will have some value, although that value does and will continue to fluctuate with global economic growth.

### When to Buy...and Sell

You may be licking your chops over the potential these commodities ETFs can deliver; just don't jump into them without a firm plan for buying and selling.

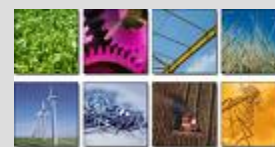
We recommend that you buy only those ETFs trading above their 200-day moving averages (see the end of this report for a list)—then come up with an exit strategy immediately. Commodities are not meant to buy-and-hold. They follow specific trends, and it is wise to monitor where they're trading with respect to this long-term average. Once you buy, set a specific stop-loss of 8% below your buy price or its high, whichever comes first.



This will help keep your emotions out of the investment equation. Rationalizing your moves or hoping for a turnaround is a guaranteed ticket to trouble.

Follow the trends, stick to a sell discipline and think with your brain, not your gut.

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Description	Ticker Symbol	Assets	Performance (as of 5/ 23/08)			% Above or Below 200-Day Moving Average
			1-Month	Year-to-Date	1-Year	
<b>Market Indexes</b>						
Dow Jones Industrial Average			-2.2%	-5.9%	-7.8%	-2.8%
S&P 500			-0.3%	-6.3%	-9.7%	-2.4%
Nasdaq			1.6%	-7.8%	-5.5%	-0.7%
<b>Broad Based Commodities</b>						
PowerShares DB Commodity Index Tracking Fund	DBC	\$2.5 billion	7.8%	32.6%	65.2%	24.5%
iShares S&P GSCI Commodity Indexed Trust	GSG	\$778 million	8.0%	32.5%	68.2%	26.7%
iPath Dow Jones AIG Commodity Index Fund	DJP	\$3.4 billion	2.3%	19.6%	31.4%	13.4%
<b>Agriculture</b>						
PowerShares DB Agriculture	DBA	\$2.6 billion	-4.4%	9.6%	44.4%	4.9%
Market Vectors Global Agribusiness	MOO	\$1.7 billion	-3.1%	7.1%	NA	15.2%
Elements Rogers International Commodity Agricultural ETN	RJA	\$309 million	-3.8%	1.5%	NA	-0.4%
<b>Energy</b>						
United States Oil	USO	\$467 million	12.4%	41.1%	114.2%	37.4%
PowerShares DB Energy	DBE	\$121 million	13.0%	44.5%	85.5%	37.6%
United States Gasoline	UGA	\$17 million	11.1%	NA	NA	20.8%
iShares Dow Jones U.S. Energy Sector Index Fund	IYE	\$1.2 billion	2.5%	9.0%	27.1%	14.1%
iPath S&P GSCI Crude Oil Total Return Index	OIL	\$107 million	11.7%	40.7%	116.1%	37.2%
<b>Precious Metals</b>						
SPDR Gold Shares	GLD	\$16.3 billion	2.3%	10.8%	39.9%	9.2%
iShares COMEX Gold Trust	IAU	\$1.7 billion	2.4%	10.7%	39.7%	9.1%
PowerShares DB Gold	DGL	\$78 million	2.4%	9.4%	35.8%	8.6%
iShares Silver Trust	SLV	\$3.1 billion	6.0%	22.8%	39.8%	12.9%
<b>Base Metals</b>						
Market Vectors Steel	SLX	\$347 million	7.2%	26.0%	66.2%	26.4%
PowerShares DB Base Metals	DBB	\$111 million	-3.3%	14.6%	-2.6%	1.7%

This list is of those ETFs and ETNs mentioned in the full commodity report. It does not include all commodity ETFs and ETNs.