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Making Sense of Commodities' Wild Ride

Even though gold and oil have taken a beating, investors shouldn't panic. Commodities still have a place in well-diversified portfolios

by Aaron Pressman

For commodity investors, the past week wasn't just a wild ride—it was the wildest in modern history. Gold fell $114 an ounce, or 11%, in three days after hitting an all-time intraday high of $1,033.90 on Mar. 17. Oil, too, plummeted almost 10% after hitting its all-time record of $111.80. Overall, the Reuters/Jeffries CRB Index lost 8%, the worst week since the compilation of 19 commodity prices was created in 1956.

Of course, even with the sudden declines of the past week, commodity prices are still well above year-earlier levels. Oil, for example, still trades about 80% higher than a year ago.

The head-spinning gyrations have shocked investors who have been told for the past few years to get into commodities amid a boom in new funds and securities tied to commodity prices. And commodity skeptics are out in force warning that the five-year bull market has flipped.

A DOLLOP WILL DO YOU GOOD

"Every 25 years you get a four- or five-year run in commodities," says investment adviser Rick Ferri, founder and chief executive of Portfolio Solutions in Troy, Mich. "But they only help your returns if you get in and out just right. Good luck with that."

It's a fair warning for anyone who tried to guess which way commodity prices would head next. Despite the volatility and long periods of poor returns, commodities remain an important component of a well-diversified portfolio, academic research indicates. Adding a dollop of commodities to investments in stocks and bonds lowers risk and may slightly enhance returns over the long term.

"On their own, it's true that commodities are volatile and don't return much more than inflation," explains Larry Swedroe, director of research at Buckingham Asset Management in Clayton, Mo. "It's the diversification benefit they provide when you look at the totality of your portfolio that makes commodities a great hedge."

PROVEN DIVERSIFICATION BENEFITS

Viewed as an insurance policy, commodities have performed well over the past 40 years. In the nine years since 1970 when bonds posted negative returns, commodities rose every time by an annual average of 30%, Swedroe says. And in the eight years since 1970 that stocks dropped, commodities rose six times, posting an average annual gain of 23% (even including the two years they fell in line with stocks).

Duke University Professor Campbell Harvey and TCW Group Managing Director Claude Erb came to the same conclusion in their seminal study of commodity returns, published in 2006. While the researchers found that commodity prices alone barely outpaced the rate of inflation, they still concluded the diversification benefit was real. The paper won last year's Graham & Dodd Award from the CFA Institute's *Financial Analyst Journal.*

And even Harvey has a few warnings for investors. He's no fan of trying to jump on the commodity train as a speculative bet. He warns: "Beware of trying to buy things that near the all-time highs." Harvey's also not a fan of one of the most widely used commodity indexes, the Standard & Poor's Goldman Sachs Commodity Index (Standard & Poor's, like BusinessWeek.com, is owned by The McGraw-Hill Companies (MHP)). The index is too concentrated with about 70% of its weighting in energy commodity futures, Harvey says: "It's not diversified enough—it's a bet on energy prices."

BEN BERNANKE TO THE RESCUE

It's useful to put the week's frightful plunge in commodity prices in context. The move followed the Federal Reserve's dramatic moves to bolster confidence in the U.S. financial system. Commodities have been rising of late on fears that low U.S. interest rates would further weaken the dollar and let inflation run rampant. Gold, oil, and other markets also benefited from fears that financial chaos might spiral out of control. Fed Chairman Ben Bernanke helped assuage some of those fears this week, organizing a takeover of Bear Stearns while cutting rates less than expected at the central bank's Mar. 18 Federal Open Market Committee meeting.

The debate still rages over whether commodity prices have peaked. Volatile downdrafts lasting for a few days have been a common occurrence during the rise in commodity prices over the past two years, Barclays Capital (BARC) noted in a report after markets closed on Mar. 20. "There has been little change in underlying fundamentals, which on the whole remain very positive for a wide range of different commodities and even after recent declines the prices of most commodities are still a long way above month-ago levels," the firm wrote.

The benefits of diversification were clearly on display in the week's commodity plunge. Even as commodity prices dropped, the stock market rose sharply. The Standard & Poor's 500-stock index gained more than 3%, including a 12% spike in financial-sector shares. "I'm very happy when commodities do [poorly]," quips Swedroe in language too colorful to repeat here. "If commodities are doing poorly, usually stocks are doing great."

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