

# Research:

## Commodities vs. Companies

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Do commodity ETFs belong in your clients' portfolios? Some advisors feel exposure to stocks, bonds, real estate and cash offers most people all the diversification and asset coverage they'll ever need. However, other advisors are adding commodities as another major asset class.

Commodity Categories	Name and Ticker	Expense Ratio
Equities	Market Vectors RVE Hard Assets Producers ETF (HAP)	0.65%
	Materials Sector SPDR (XLM)	0.21%
	TR/Jefferies CRB Global Commodity ETF (CRBQ)	0.65%
Broadly Diversified	iShares S&P GSCI Commodity Index Trust (GSG)	0.75%
	Greenhaven Continuous Commodity Index Fund (GCC)	0.85%
	PowerShares DB Commodity Index Tracking Fund (DBC)	0.85%
Agriculture	iPath Dow Jones-UBS Agriculture TR Sub-Index ETN (JJA)	0.75%
	PowerShares DB Agriculture Fund (DBA)	0.85%
Energy	PowerShares DB Energy Fund (DBE)	0.78%
	UBS E-TRACS Bloomberg CMCI Energy Index ETN (UBN)	0.85%
Metals	iShares COMEX Gold Trust (IAU)	0.25%
	SPDR Gold Shares (GLD)	0.40%
	ETFs Physical Precious Metals Basket Shares (GLTR)	0.60%
	PowerShares DB Base Metals (DBB)	0.78%
	UBS E-TRACS Bloomberg CMCI Industrial Metals ETN (UBM)	0.65%
Long Leveraged	ProShares Ultra DJ-UBS Commodity ETF (UCD)	0.95%
	ProShares Ultra DJ-UBS Crude Oil (UCO)	0.95%
	ProShares Ultra Gold (UGL)	0.95%
	PowerShares Agriculture Double Long ETN (DAG)	0.75%
Short Leveraged	ProShares UltraShort DJ-UBS Commodity ETF (CMD)	0.95%
	ProShares UltraShort DJ-UBS Crude Oil (SCO)	0.95%
	ProShares UltraShort Gold (GLL)	0.95%
	PowerShares Agriculture Double Short ETN (AGA)	0.75%

"We do utilize commodities in our client portfolios and they make up roughly 4 percent of our standard 60/40 portfolio," says Jeffrey E. Janson, CFP with Financial Advisory Corporation in Grand Rapids, Mich.

Many factors impact the price and cost of commodities, including geopolitical tensions, weather and war. This makes the dynamics of investing in commodities very different from investing in commodity-related equities.

That's one reason some advisors prefer staying with stocks. "For our model portfolios, we have a strategy of sticking to ETFs that invest in companies in the commodity industry, as opposed to investing into ETFs that invest into commodity futures or physical commodities," states Michael McClary chief investment officer at ValMark Advisers. "We use the Vanguard Energy ETF (VDE), Vanguard Materials ETF (VAW) and the Guggenheim Timber ETF (CUT) extensively." ValMark manages \$850 million in its model ETF portfolios.

Some advisors are hesitant to use exchange-traded products that invest in commodities through futures contracts because of operational issues. These problems were exacerbated last year when the Commodity Futures Trading Commission set restrictions on positions in futures contracts that exchange-traded products could buy.

That caused some products like the iShares S&P GSCI Commodity Indexed Trust (GSG) to temporarily halt the issuance of new shares and effectively trade like closed-end funds for a period of time. Other products like the PowerShares DB Commodity Index Tracking Fund (DBC) were forced to change their indexing strategy.

"While we like the low cost that the ETFs generally provide, there are several structural issues that have caused us to decide against ETFs when looking for broad-based commodity exposure, says Janson. "These structural issues include significant energy overweighting in the index construction

methodology, roll yield issues of contango and backwardation and price tracking error.”

Commodity ETFs that invest in commodity futures rather than taking delivery of the physical commodities must roll their futures positions every month into new contracts as the old contracts expire. If future commodity contracts are more expensive than spot prices, this creates a situation called contango. In this case, the commodity fund is likely to produce negative returns, as it replaces expiring contracts with higher priced contracts.

When spot commodity prices are more expensive than future prices, the opposite of contango occurs. This is known as backwardation. Steep backwardation often indicates the marketplace perception that an immediate shortage of a particular commodity is at hand.

“Ultimately, we don’t want the particular challenges that indexing commodities present to inadvertently taint our client’s view of ETFs in general,” adds Janson.

### **Getting Physical**

Some advisors, however, are taking a more “physical” approach to investing in commodities. Consider: two metals-backed ETFs, the iShares COMEX Gold Trust (IAU) and the SPDR Gold Shares (GLD), alone command almost \$60 billion in assets. Both products take physical delivery of gold bullion bars and store them in secure locations.

Another twist on the same theme is the ETFS Physical Precious Metal Basket Shares (GLTR), which owns physical gold, silver, platinum and palladium in fixed equal weights of 25 percent. GLTR’s annual expense ratio is 0.60 percent.

“For now, we have decided to utilize an actively managed fund, the Van Eck Global Hard Assets (GHAAX), for our commodity exposure. In due time, if the various providers are able to adequately resolve the operational problems, we will reevaluate their potential inclusion in our portfolios,” says Janson.

### **Seeking Permanence**

One strategy that incorporates commodities exposure is the “Permanent Portfolio” concept, which was developed by free-market investment analyst Harry Browne in the early 1980s. Browne assembled an investment portfolio that gave equal exposure to growth stocks, precious metals, cash and government bonds. According to his theory, this type of investment mix would be safe and profitable in any kind of economic cycle.

Using Browne’s ideas as the basis for an investment strategy, the Permanent Portfolio mutual fund (PRPFX) was launched in 1982. Despite lagging the S&P 500 index (SPY) since its inception, the Permanent Portfolio has produced an after tax gain of 9.34 percent over the past 10 years compared to the S&P’s 1.59 percent loss.

Here’s an example of corresponding ETFs that match the Permanent Portfolio’s asset mix: 25 percent in total U.S. stock market (VTI); 25 percent in long-term Treasuries (TLT); 25 percent in gold (IAU); 25 percent in short-term Treasuries (SHY).

Even though the Permanent Portfolio theory has worked well over the past decade, there are a few caveats to keep in mind.

First, its performance is likely lag stocks in a rising market because of its heavy exposure to cash, bonds and precious metals. Also, long-periods of underperformance for precious metals, like 1980-2008, will put a damper on future performance. Perhaps, substituting a more diversified commodity fund in the place of gold might be the answer.

### **Making Choices**

Deciding whether to add commodities exposure and how to execute are matters of preference and philosophy. “Commodity producers are the way for most investors to profit from a roaring commodity bull market,” argues John Stephenson, portfolio manager and author of *The Little Book of Commodity Investing* (Wiley 2010).

Taxes are another important factor to take into account. From an asset location perspective, both physical and futures-based commodity ETFs/ETNs are best held in tax-deferred accounts for their lack of tax efficiency.

Generally, commodity-linked products that utilize futures to obtain their market exposure receive special tax treatment. Regardless of the holding period, 60 percent of gains are taxed at the long-term capital gains rate while the remaining 40 percent of gains are taxed as short term profits, subject to the investor’s ordinary income tax rate.

For investors in the highest tax bracket, this 60/40 split creates a maximum blended capital gains tax rate of 23 percent. The tax burden is reduced for investors in lower income brackets.

Products that own physical precious metals are taxed as collectibles with a maximum long-term capital gains rate of 28 percent. This would put equity based commodity investments at a tax savings advantage assuming capital gains rates remain the same.

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