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# The role of basic goods in balanced portfolios

THE market often has strong, conflicting ideas regarding the timing and desirability of investing in commodities. But why invest in commodities?

Where investments are concerned, commodities are defined as the basic goods used in the production of goods and services that are interchangeable with other commodities of the same type. Agricultural and mining products are typical commodities.

When people refer to trading in “commodities” or “natural resources”, they refer mostly to the buying and selling of the physical goods on exchanges that create a market for those transactions.

The term “commodity stocks”, however, refers to the shares of companies that produce and sell these resources in a pure or altered form. As the JSE top 40 is dominated by large mining companies, the performance of our market can be related quite closely to commodity producers.

This provides two broad ways in which to profit from a rise in commodity prices.

The first would be to buy shares in companies that would see their revenues increase where the price of the product they produce increases — assuming that their input costs remain relatively stable. The second, more direct path involves trading futures contracts — agreements to purchase or sell a commodity at a specific price for delivery in the future.

Investors can trade in and out of futures contracts without ever taking delivery of the product.

Why invest in commodities without the intention to use them?

Commodities are a way to balance your portfolio as commodity price performance can often run inversely to other stocks.

As SA is the world’s largest producer of platinum, a crisis at Impala Platinum or Anglo Platinum mines can lead to an increase in the price of the commodity they produce.

Secondly, hard commodities (which are typically mined or extracted) cannot easily be replaced and were created in finite quantities, which help them to store value.

Thirdly, commodities provide a hedge against inflation. Certain US analysts have warned that the end of the economic crisis will see all the money sitting on the sidelines — including 3,9-trillion that households have in money market unit trust funds and the 7,5-trillion held in interest-bearing bank accounts — come rushing out.

China recently announced that economic growth in the first half of this year was 7,1%.

This could introduce serious inflation and possibly a devaluation of the dollar's value against other currencies. As almost all commodities are priced in dollars, the prices of these commodities will increase.

This will protect investors against the depreciation of other asset classes that follows the depreciation of the currency.

This strategy should, however, be approached with caution. Gold and silver are better hedges against wars and other crises than against inflation. But gold is also susceptible to bubbles of its own, and individual commodity prices are volatile and risky.

And commodities do not pay dividends or interest, leaving investors reliant on price growth.

Any investment in commodities should be approached with caution, but can reward investors in a balanced portfolio. After all, the performance of the JSE top 40 has been quite spectacular over the past 20 years.

*- John Vorster is director of online trading at PSG Online.*