Chapter 1

Investors, Start Your Engines! An Overview of Commodities

In This Chapter

- Finding out why you should invest in commodities
- Defining the commodities markets
- Determining the best ways to trade commodities
- Identifying the major 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. (I cover almost all of them — 32, to be exact — more than any other introductory book on the topic.) 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. 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. You've maybe 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 money-making opportunities.

For example, a lot of folks equate (incorrectly) commodities exclusively with the futures markets. Undoubtedly, the two are inextricably linked — the futures markets offer a way for commercial users to hedge against commodity price risks and a means for investors and traders to profit from this price risk. However, the futures market is only one planet in the commodities universe.

Commodities throughout history

The history of commodities tells the story of civilization itself. Ever since man first appeared on earth, his existence has been defined by a perpetual and brutal quest for control over the world's natural resources. Civilizations rise and fall, nations prosper and perish, and societies survive and subside based on their ability to harness energy, develop metals, and cultivate agricultural products — in short, based on their capacity to control commodities. It's interesting to note that prehistoric times are still defined today by the subsequent stages of man's mastery of the metals production process: the Stone Age, the Bronze Age, and the Iron Age. Nations that have been able to master natural resources have survived, while those that failed have faced extinction. This sobering reality has led to some of the most epic clashes among civilizations.

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.

A few centuries later, this continuous quest for commodities resulted in the deadly South African Boer Wars at the end of the 19th century, 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 take into account 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.

The equity markets are also deeply involved in commodities. Companies such as ExxonMobil (NYSE: XOM) focus exclusively on the production of crude oil, natural gas, and other energy products; Anglo-American PLC (NASDAQ: AAUK) focuses on mining precious metals and minerals across the globe; and Starbucks (NASDAQ: SBUX) offers investors access to the coffee markets. Ignoring these companies that process commodities isn't only narrow minded, but it's also a bit foolish because they provide exposure to the very same commodities traded on the futures market.

In addition to the futures and equity markets, a number of investment vehicles allow you to access the commodities markets. These vehicles include master limited partnerships (MLPs), exchange-traded funds (ETFs), and commodity mutual funds (all covered in Chapter 6). So although I do focus on the futures markets, I also examine investment opportunities in the equity markets and beyond.

The commodities universe is large, and investment opportunities abound. In this book, I help you explore this universe inside and out, from the open outcry trading pits on the floor of the New York Mercantile Exchange to the labor-intensive cocoa fields of the Ivory Coast; from the vast palladium-mining operations in northeastern Russia to the corn-growing farms of Iowa; from the Ultra Large Crude Carriers that transport crude oil across vast oceans to the nickel mines of Papua New Guinea; from the sugar plantations of Brazil to the steel mills of China.

By exploring this fascinating universe, not only do you get insight into the world's most crucial commodities — and get 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

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 they are the essential building blocks of the global economy.

For the purposes of this book, I present 32 commodities that fit a very specific definition, which I define in the following bulleted 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 a raw material; they can't be physically used to build anything. In addition, the commodities must present real moneymaking opportunities to investors.

All the commodities I cover in the book have to 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 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.
- **Liquidity:** I don't include any commodities that trade in illiquid markets. Every commodity in the 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.

Follow the money

Commodities have allowed nations to survive and thrive, but they've also given individuals tremendous wealth-accumulation possibilities. Some of the world's most enduring fortunes have been built around commodities. Mayer Rothschild, patriarch of the European Rothschild banking family, made a fortune during the Napoleonic Wars by storing and distributing gold bullion to fund the British side of the war effort.

Andrew Carnegie, the self-made industrialist and founder of the eponymous steel company that eventually became U.S. Steel, consolidated the American steel industry and, in the process, became the second-richest man of his time, behind only John D. Rockefeller, Sr. And what better illustration of the power of commodities as wealth-building vehicles is there than John Rockefeller himself, whose impact on the global oil industry through the creation of the Standard Oil Company is still felt today? (See Daniel Yergin's *The Prize: The Epic Quest for Oil, Money and Power.*) Abdel-Aziz Al-Saud, Saudi Arabia's first monarch, consolidated and created an entire nation through the control of crude oil and natural gas riches.

To this day, individuals involved in commodities have been able to generate tremendous wealth. Legendary oilman T. Boone Pickens, for instance, made $1.4 billion in 2005 by betting on the price of oil and natural gas. Lakshmi Mittal, the Indian-born steel magnate, became the world's fourth-richest person in 2004 as a result of his business activities in the steel industry. Clearly, individuals who have the foresight to invest in commodities have profited handsomely from this enterprise. You may not be able to build as much wealth as Rockefeller or Al-Saud, but I'm confident that you can benefit by opening up to investing in commodities.

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 9.

REMEMBER

The futures markets are administered by the various commodity exchanges, such as the Chicago Mercantile Exchange (CME) and the Intercontinental Exchange (ICE). I discuss the major exchanges, the role they play in the markets, and the products they offer in Chapter 8.

TIP

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 9.

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):** The CPO is similar to a CTA, except that the CPO 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 6.

REMEMBER

These examples are only a few ways to access the futures markets. Be sure to read Chapters 5 and 6 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. Check out Chapter 8 for an in-depth analysis of the role these regulators play and how to use them to protect yourself from market fraud.

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 simply jump into futures — 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 take into account 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 the 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 these types of companies in the 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 18.
- **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 have historically offered large dividends to shareholders. Read Chapter 13 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 14).

REMEMBER

This list is only a small sampling of the commodity companies I cover in these pages. I also analyze highly specialized companies, such as coal-mining companies (Chapter 13), oil refiners (Chapter 14), platinum-mining companies (Chapter 15), and purveyors of gourmet coffee products (Chapter 19).

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 7 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:

- **Exchange-traded funds (ETFs):** ETFs are an increasingly popular investment because they're managed funds that offer the convenience of trading like stocks. In recent years, a plethora of ETFs has appeared to track everything from crude oil and gold to diversified commodity indexes. Find out how to benefit from these vehicles in Chapter 5.
- **Mutual funds:** If you've previously invested in mutual funds and are 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 6.

If you have a pet or a child, sometimes you hire a pet sitter or babysitter to look out after your loved ones. 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 cat, daughter, or both. The same thing applies when you're shopping for a money manager, or money sitter. If you already have a money manager you trust and are happy with, stick with him. If you're looking for a new investment professional to look after your investments, you need to investigate him as thoroughly as possible. In Chapter 7, 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 a great example of this. As 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 15.

This investment strategy is suitable for only 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 32 commodities in the book. Here's a listing of all the commodities you can expect to encounter while going through these pages. (Although the book is modular in nature, I list the commodities here in order of their appearance in the text.)

Energy

Energy has always been indispensable for human survival and also 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. I present in this book 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, coal 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 liquefied natural gas (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.

Other commodities are in the energy complex, such as heating oil, propane, and gasoline. Although I do provide insight into some of these other members of the energy family, I focus a lot more on the resources in the previous list.

Metals

Metallurgy has been essential to human development since the beginning of time. Societies that have mastered the production of metals have been able to thrive and survive. Similarly, investors who have incorporated metals into their portfolios have been able to generate significant returns. I cover all the major metals, from gold and platinum to nickel and zinc.

- **Gold:** Gold is perhaps the most coveted resource on the planet. For centuries, people have been attracted to its quasi-indestructibility and have used it as a store of value. Gold is a good asset for hedging against inflation and also for asset preservation during times of global turmoil.
- **Silver:** Silver, like gold, is another precious metal that has monetary applications. The British currency, the pound sterling, is still named after this metal. Silver also has applications in industry (such as electrical wiring) that places it in a unique position of being coveted for both its precious metal status and its industrial uses.
- **Platinum:** Platinum, the rich man's gold, is one of the most valuable metals in the world, used for everything from jewelry to the manufacture of catalytic converters.
- **Steel:** Steel, which is created by alloying iron and other materials, is the most widely used metal in the world. Used to build everything from cars to buildings, it's a metal endowed with unique characteristics and offers good investment potential.
- **Aluminum:** Perhaps no other metal has the versatility of aluminum; it's lightweight yet surprisingly robust. These unique characteristics mean that it's a metal worth adding to your portfolio, especially because it's the second most widely used metal (right behind steel).
- **Copper:** Copper, the third most widely used metal, is the metal of choice for industrial uses. Because it's a great conductor of heat and electricity, its applications in industry are wide and deep, making this base metal a very attractive investment.
- **Palladium:** Palladium is part of the platinum group of metals, and almost half of the palladium that's mined goes toward building automobile catalytic converters. As the number of cars with these emission-reducing devices increases, the demand for palladium will increase as well, making this an attractive investment.
- **Nickel:** Nickel is a ferrous metal that's in high demand because of its resistance to corrosion and oxidation. Steel is usually alloyed with nickel

to create stainless steel, which ensures that nickel will play an important role for years to come.

- **Zinc:** The fourth most widely used metal in the world, zinc is sought after for its resistance to corrosion. It's used in the process of galvanization, in which zinc coating is applied to other metals, such as steel, to prevent rust.

Agricultural products

Food is the most essential element of human life, and the production of food presents solid money-making opportunities. In *Commodities For Dummies,* 2nd Edition, you find out how to invest in the agricultural sector in everything from coffee and orange juice to cattle and soybeans.

- **Coffee:** Coffee is the second most widely produced commodity in the world, in terms of physical volume, behind only crude oil. Folks just seem to love a good cup of coffee, and this provides good investment opportunities.
- **Cocoa:** Cocoa production, which is dominated by a handful of countries, is a major agricultural commodity, primarily because it's used to create chocolate.
- **Sugar #11:** Sugar is a popular food sweetener, and it can be a sweet investment as well. Sugar #11 represents a futures contract for global sugar.
- **Sugar #14:** Sugar #14 is specific to the United States and is a widely traded commodity.
- **Frozen concentrated orange juice — type A:** FCOJ-A, for short, is the benchmark for North American orange juice prices because it's grown in the hemisphere's two largest regions: Florida and Brazil.
- **Frozen concentrated orange juice — type B:** FCOJ-B, like FCOJ-A, is a widely traded contract that represents global orange juice prices. This contract gives you exposure to orange juice activity on a world scale.
- **Corn:** Corn's use for culinary purposes is perhaps unrivaled by any other grain, which makes this a potentially lucrative investment. Check out how to trade it in Chapter 20.
- **Wheat:** According to archaeological evidence, wheat was one of the first agricultural products grown by man. It's an essential staple of human life and makes for a great investment.
- **Soybeans:** Soybeans have many applications, including as feedstock and for cooking purposes. The soybean market is a large market and presents some good investment opportunities.

- **Soybean oil:** Soybean oil, also known as vegetable oil, is derived from actual soybeans. It's used for cooking purposes and has become popular in recent years with the health-conscious dietary movement.
- **Soybean meal:** Soybean meal is another derivative of soybeans that's used as feedstock for poultry and cattle. It may not sound sexy, but it can be a good investment.
- **Live cattle:** For investors involved in agriculture, using the live cattle futures contract to hedge against price volatility is a good idea.
- **Feeder cattle:** Whereas the live cattle contract tracks adult cows, the feeder cattle contract hedges against the risk associated with growing calves. The markets don't widely follow this area, but it's important to figure out how this market works.
- **Lean hogs:** They may not be the sexiest commodity out there, but lean hogs are an essential commodity, making them a good trading target.
- **Frozen pork bellies:** Frozen pork bellies are essentially nothing more than good old bacon. This industry is cyclical and subject to wild price swings, which provides unique arbitrage trading opportunities.