17.3: Commodities and Collectibles

Learning Objectives

1. Define and describe the characteristics and uses of derivative contracts.
2. Explain the roles of precious metals in an investment portfolio.
3. Describe the methods available to individual investors in making commodities investments.
4. Compare and contrast the advantages and disadvantages of using collectibles in an individual investment portfolio.

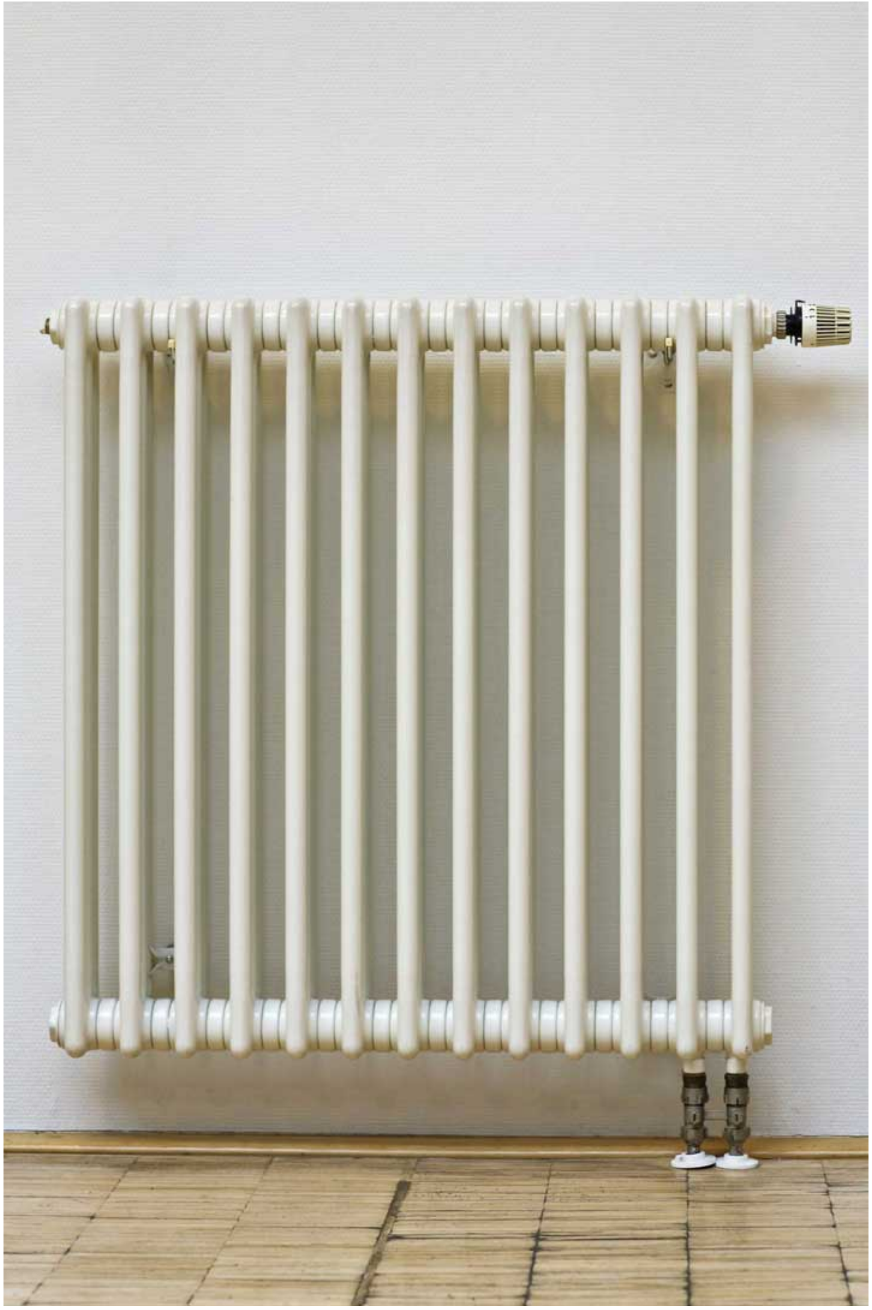
Some investors prefer to invest directly in the materials that are critical to an industry or market, rather than investing in the companies that use them. For example, if you think that the price of oil is going to rise, one way to profit from the higher price would be to buy shares of oil companies that profit by refining oil and selling gasoline, fuels, and other petroleum products. Another way is to buy the oil itself as a commodity.

Commodities are raw materials—agricultural products, metals, energy sources, currencies, and so on—that go into producing goods and services. Investing in commodities is a way to profit directly from the raw material rather than from its products. As discussed in Chapter 12, commodities trading is not new—the first commodities exchange in the United States was established in 1848.

Because they are or rely on natural resources, commodities have a largely unpredictable supply. They have inherent risk, because they are exposed to changes in weather or geology or global politics. Commodities trading began as a way for commodity producers and consumers to manage their risks. These traders are managing risks going forward; that is, they hedge by buying and selling commodities that they expect to exist in the future. This trading is done using future and forward contracts—types of derivatives, discussed in the Chapter 12.

Investing in commodities involves transaction costs and a time limit on realizing your gains (or losses), because derivatives are time-sensitive contracts created with an expiration date.

Commodity investing is risky business, because it is done through derivatives—assets whose value depends on the value of another asset. For instance, the value of a contract to buy or sell soybeans at some time in the future depends on the value of the soybeans. When you invest in a derivative, you are taking on the risk of both contract and the asset that it depends on. One strategy to manage this risk is to invest in both, creating a situation in which one investment can act as a hedge for the other. The way this works is if the underlying asset (the soybeans) gains value, you'll lose on the derivative (the futures contract on soybeans); but if the asset loses value, you can gain on the derivative.



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One example of this is the “prebuy” offer common in regions where homes are heated by oil. When you heat your home with oil, you are exposed to the risk of volatility in the price of oil. This volatility can upset your household budget and, since heat is a necessity, can take away from your other spending needs. You could guarantee your winter’s cost of oil by buying it all in the summer, but you would need a huge oil tank to store all that oil until winter. As an alternative and to attract customers, some heating oil suppliers offer a prebuy deal. During the summer, customers can buy their winter’s supply of oil at a set price, and the oil company will then deliver it as needed over the winter months.

If the price of oil goes up, the customer is protected and gains by not having to pay the higher price. The oil dealer loses the extra profit it could have had. On the other hand, if the price of oil goes down, the dealer is assured its profit, while the customer pays more than necessary without the prebuy deal.

In the language of commodities trading, the customer is “short” oil, that is, needs it and seeks to lock in a price through the prebuy deal. The oil dealer is “long” oil, that is, has a supply and wants to sell it and so seeks to lock in the sale of a certain quantity at a certain price. The customer wants to lock in a low price, while the dealer wants to lock in a high price. Each is betting on what will be “low” and “high” relative to what the real price of oil turns out to be in the future. The hedge of the prebuy deal relieves both the customer and the dealer of the uncertainty or risk. The deal creates its own risks, but if those are smaller than the risk of oil’s price volatility, then the dealer will offer the prebuy, and the customer will take it.

When you trade commodities, you are also exposed to the risks of trading in the commodities markets. Another reason that commodities investing is risky for individual investors is because professional commodity investors often take speculative positions, betting on the future price of derivatives without holding investments in the underlying assets. Speculators can influence that future price, which after all is just the market’s consensus of what that price “should” be. For individual investors, the risks of commodities trading often outweigh the advantage of whatever diversification they bring to the portfolio.

Gold, Silver, and Precious Metals

Historically, gold and silver have been popular investments of individual investors. For thousands of years, gold and silver have been used as a basis for currency value, either minted into coins or used to back currency value. When a currency is backed by gold, for example, or is “on the gold standard,” there should be a direct relationship between the value of the currency and the value of the gold.

In times of inflation or deflation, investors worry that the value or purchasing power of currency will change. They may invest in gold or silver as a more stable store of wealth than the currency that is supposed to represent the metal. In other words, if investors lose faith in the currency that represents the gold, they may trade their money for the gold.

Most currencies used today are not backed by a precious metal but by the productivity and soundness of the economy that issues them. For example, the value of the U.S. dollar is not related to the value of an ounce of gold, but to the value of the U.S. economy.

When economic or political turmoil seems to threaten the health of an economy and hence the value of its currency, some investors choose to invest in the gold or silver that seems to retain its value. For that reason, gold or silver has historically been regarded as a hedge against inflation.

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How exactly do you buy gold? Gold bullion is sold as bars or wafers in units of one kilogram or 32.15 troy ounces. Metal dealers and some banks will sell bars or wafers ranging from 5 grams (or 0.16075 troy ounces) to 500 ounces or more. Transaction costs are relatively high, between 5 percent and 8 percent, and there is the cost of storing and securing the gold bars or wafers.

A more popular way to buy gold is as coins, which are more easily stored and secured. Gold coins are minted by several countries, including the United States, and may be bought from banks, brokers, and dealers for a fee of about 2 percent.

Commodity Indexes and Exchange-Traded Funds

As with stocks, bonds, and real estate, the most popular way for individual investors to invest in any commodities—including precious metals—is through open-end mutual funds or exchange-traded funds (ETF). The fund may invest in a variety of contracts, diversifying its holdings of the commodity. It has professional managers who understand the pricing of such contracts and can research the market volatility and the global economy. Using a fund as a way of investing in commodities thus provides both diversification and expertise. It can also give you more liquidity as fund shares can be quickly traded into the market.

For example, if you expect inflation and want to buy gold, instead of trying to buy gold bars, you could invest in a fund (iShares), an exchange-traded fund (Comex Gold), or mutual funds (Fidelity Select Gold or Vanguard Precious Metals). These funds allow you to “own” gold but also to get diversification, expertise, and liquidity, reducing your risk.

There are mutual funds or exchange-traded funds for nearly every commodity that is traded. There are also passively managed commodity index funds, similar to stock or bond index funds. Investing in commodities can be a way to achieve asset diversification in your portfolio, because often a commodity such as gold is countercyclical to the economy, and therefore is countercyclical to your stock and bond holdings as well. Commodities may also add significant risk to a portfolio, however, so the advantage of adding them as a diversification strategy may be canceled out by the additional risk.

Collectibles and Unique Investments

Any asset that is tradable may become an investment; that is, it may be purchased and held with the expectation that it can be sold when its value increases. So long as there is a market for it—a buyer—it potentially may be sold at a gain.

Collectibles and unique investments include the following:

- Antique furniture
- Stamps
- Coins
- Rare books
- Sports trading cards
- Vintage cars
- Vintage clothes
- Vintage wines
- Vintage vinyl
- Fine art
- Musical instruments
- Jewelry
- Historical curios
- Other ephemera

As investments, collectibles cannot be standardized in the way that stocks, bonds, or even real estate and used cars can be. Each asset has attributes that make it more or less valuable, even among similar assets. Its value is hard to judge, and therefore it is harder for buyer and seller to agree on a price.

Professional appraisers are knowledgeable about both the item and the market and are trained to evaluate such assets. Theirs is a better-educated guess, but it is still just an estimate of value. Individual investors also consult books on collectibles and may purchase professional market research, pricing indexes, and auction records.

Sometimes one person’s trash is another person’s treasure. It is fun to think that you may unearth a rare “find” at a garage sale or flea market or that some family heirloom has more than sentimental value. Usually, however, your ability to cash in on your luck is limited by your ability to convince someone else of its worth and to sell when its market is trendy.

Collectibles, including “ephemera” such as antique letters and photographs, are usually sold by dealers or collectors or through a private sale arranged between buyer and seller. The dealers may establish a gallery to showcase items for sale. Auction houses such as Christie’s or Sotheby’s organize auctions of many items or “lots” to attract buyers and provide catalogues with details on the items for sale, such as their “provenance” or ownership history.

The advantage of unique assets as investments is that you may enjoy collecting and having the items as well as watching their value appreciate. If you are a guitarist, for example, having and being able to play a vintage guitar may mean more to you than the fact that it may be a good investment. For some, collecting becomes a hobby.

The disadvantages of investing in collectibles are

- high probability of mispricing, as markets are inefficient;
- lack of liquidity;
- lack of earnings, as there are no dividends or interest;
- holding costs of the investment.

Unless you are knowledgeable about your item and its markets (and even if you are), it is common to suffer from mispricing. Collectibles' markets are relatively inefficient because trading partners vary widely in their knowledge about pricing. Both buyers and sellers try to persuade each other of an asset's rarity and value. It is easy to be misled and to make mistakes in this market. Online sales and auctions of collectibles at sites such as eBay may be fun for hobbyists, but they typically are not good venues for investors.

If you are trading through a dealer, you can check the dealer's reputation through professional organizations, local business bureaus, and Internet blogs and Web sites, especially where customers can provide a rating or critique. You should also always try to find comparable items to compare prices. If feasible, get a second opinion from an independent appraiser. Knowledge is an important bargaining chip. The more you know, the more likely you are to be satisfied with your investment decision, even if you ultimately walk away from the deal.

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Unique investments may not be readily saleable, or their markets may be subject to trends and fashions that cause price volatility. This means that your investment may ultimately be a source of gain but that you cannot count on it as a source of liquidity. If you have foreseeable liquidity needs, it may not be appropriate to tie up your wealth in a Chinese vase, autographed baseballs, vintage action figures, or Navajo rugs.

There are no dividends or interest paid while you hold collectibles, so if you have income needs you should choose a more useful investment. There are also other costs, such as storage, security, maintenance, and insurance. Your investment actually returns a negative net cash flow—costs you more than it brings in—until you realize its potential gain by selling it.

Collectibles can be a source of joy and a store of wealth, and you may realize a healthy return on your investment. In the meantime, however, they create costs so that your eventual return will have to be large enough to compensate for those costs to make them a really worthwhile investment.

Summary

- Commodities are raw materials and agricultural products.
- Commodities are used to produce other goods and so are traded forward using derivative contracts.
- Derivative contracts can be used to hedge an investment in an asset, or to speculate on the price volatility of the commodity.
- Because of their volatility, commodities markets are riskier than asset markets.
- Precious metals, especially gold, are often used to lower portfolio risk by providing a hedge against inflation.
- Individual investors can invest in commodities using index funds and exchange-traded funds.
- Collectibles and unique assets may appreciate in value, acting as a store of wealth, but the disadvantages of using them as investments are
  - high probability of mispricing,
  - illiquid markets,
  - illiquid returns or no returns until the asset is sold,
  - holding period maintenance costs.

Exercises

1. View Bloomberg's commodities and futures charts at http://www.bloomberg.com/markets/commodities/cfutures.html. Choose one or two commodities to track and find out all you can about investing in those commodities. Read an article on how to read a commodities price chart at http://www.thegraintrader.com/chart- patterns/how-to-read-a-commodity-price-chart.html. Create an annotated drawing to apply the information about reading a commodities chart to an example of a chart taken from the Bloomberg's Web site. Write an interpretation of the chart in My Notes or your personal finance journal.
2. Read Investopedia's article on investing in gold and silver at http://www.investopedia.com/articles/optioninvestor/06/goldsilverfutures.asp. According to this source, who should consider investing in gold and silver and for what reason? What are examples of other precious metals in the futures market? How do investors offset futures contracts before their delivery dates?
3. Sample the collectibles listed on eBay at popular.ebay.com/ns/Collectibles.html. Are there any that interest you that you would consider investment grade? Why or why not? What has been your experience with buying and selling collectibles? In what circumstances might you consider adding investments in a collectible to your portfolio? What would you collect? Research this collectible to determine current pricings, locate markets, and identify dealers and experts. What would you have to sacrifice to invest in this collectible? How much could you make in the future?
