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### INVESTING

#### Hot Commodities

Prices for raw materials are soaring to meet fast-growing demand in emerging markets. Here's why that trend is sure to last—and how to profit from it.

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By Yuval Rosenberg

Does the drive to a filling station leave you feeling less than pumped these days? Record gas prices are just the most visible indication that commodities—yes, decidedly unglamorous commodities—are white-hot right now. Prices for everything from aluminum to zinc have been on a tear, and many reached multiyear highs in the first months of 2004. Copper and aluminum recently hit eight-year peaks. Platinum recorded a 24-year high.

Commodities don't mean just metals, either. Such agricultural staples as soybeans, corn, wheat, and hogs are spiking too. And oil, of course, is still at a lofty \$34 a barrel. Overall, the Reuters-CRB index of 17 actively traded commodities futures is at its highest levels since 1981. "The commodity markets," says analyst Phil Flynn of Alaron Trading in Chicago, "are on the verge of a renaissance."

Why the resurgence? It's a combination of Economics 101 and massive growth in emerging markets. A long downturn in commodity prices kept many companies from investing in new capacity. After the Asian economic crisis in 1997, weak demand for basic materials led prices to drop and eventually drove mining companies to decrease exploration for new deposits. But with economies around the world now on the upswing, producers are suddenly unable to deliver enough raw materials to supply homebuilders or electronics manufacturers. Rampaging growth in emerging markets such as Russia and India is driving demand. But no market is as ravenous for natural resources as China. (From 2001 to 2004, according to the International Iron and Steel Institute, China accounted for nearly three-quarters of the increase in global steel consumption, for

example.) Congestion at shipping ports around the world is making the supply picture even worse. And the weakness of the dollar, the primary currency in which commodities are traded, has only encouraged buyers further.

As commodity prices soar and concerns about inflation continue, smart investors have rushed to hard assets—and speculators have come in chasing the outsized recent returns. Late last year PIMCO bond guru Bill Gross announced that he favored tangible assets—so much so that he had moved some of his own money into commodities to better prepare for an inflationary upturn. In January, Merrill Lynch and Dreyfus filed plans to create mutual funds that would focus on commodity-related investments. That same month trading in gold futures at the New York Mercantile Exchange hit a record high. Copper futures set a volume record the next month.

Those developments might be signals that commodity prices are ripe for a near-term pullback. Fabled investor and long-time commodities bull Jim Rogers, for one, expects a slowdown later this year or in 2005 and notes that China has already indicated it would rein in growth and consumption. Even so, the long-term outlook for natural resources remains bright, analysts say, in large part because it takes years to bring new production onstream. "Something's going to cause a setback along the way," says Rogers, "but essentially we're in year five or six of a bull market that has another ten or 15 years to go."

How, then, to ride that bull market? With extreme caution. After all, commodities are notoriously volatile and risky. "A very little mistake can cost an awful lot of money in this business, so you have to be very careful," says Alaron analyst Flynn. Most financial advisors recommend limiting commodities to 10% or less of your total investments. Yet as a small part of a diversified portfolio, commodities can actually reduce volatility and even improve returns. That's because hard assets have tended to do well when paper assets such as stocks and bonds have fared poorly, and vice versa. From 1970 through 2003, a model portfolio with 55% stocks, 30% bonds, 10% cash, and 5% commodities outperformed one without the commodities—and was less volatile, according to research firm Ibbotson Associates. With some market watchers, such as Tobias Levkovich of Smith Barney, forecasting a painful correction in coming months, that kind of diversification may well prove valuable.

With the exception of precious metals, most investors aren't going to buy loads of raw materials—where would you store those pork bellies, anyway? That said, there are several ways to invest in commodities, with varying degrees of risk and complexity. Intrepid investors with the time and willingness to

vigilantly track the futures markets might choose to trade commodities on their own. (For more on trading futures, see "How to Get Started" on Nymex.com.) But just as most equity holders prefer to invest through a broker or mutual funds rather than trade their own accounts, investing in futures is perhaps best accomplished by putting your money with professionals.

One option is a managed futures account, available through traditional brokerage houses or commodity trading firms such as John W. Henry & Co. or Hyman Beck & Co. In a managed account, investors place their money with a commodity trading advisor, who will buy and sell a portfolio of futures on their behalf. Accounts can be set up individually or as part of pooled funds, with individual accounts typically requiring a far greater minimum investment. A major drawback to the accounts is that, like more typical hedge funds, the fees and expenses can be steep; management fees may come to 2%, plus 20% of profits. Individual futures accounts also carry unlimited risk, so before you invest, it's best to check the backgrounds of registered firms, funds, and advisors at the website of the National Futures Association ([www.nfa.futures.org](http://www.nfa.futures.org)).

Another way to sprinkle some natural resources into your portfolio is by buying a mutual fund based on a commodities index. There are only a few such funds, and the ones that do exist are relatively new. The most appealing of the group may be **Pimco CommodityRealReturn Strategy (PCRD)**, launched in November 2002 (it has not been implicated in the market-timing scandal). With \$2.1 billion in assets, the fund tracks the Dow Jones-AIG Commodity index, which has a relatively low 33% weighting in energy compared with similar indexes, and thus lower volatility. The lower exposure to energy will also help limit painful losses if oil prices retreat from current highs. Class D shares have no load and a 1.24% expense ratio. The Dow Jones index also rebalances yearly, shifting out of winners into weaker performers. "It's basically imposing a buy-low, sell-high type of mechanism," says analyst Langdon Healy of Morningstar. When dealing with commodities, that kind of forced discipline can help ensure that investors strike gold—or platinum, or nickel, or whatever else may be poised to make a run.

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