Introduction into Commodities

Commodities are unprocessed physical goods that result from mining, drilling, or agriculture. For investors, commodities offer attractive potential returns and diversification, and are often used as a tool to hedge against inflation.

What You Should Know about Commodities

The commodity market can be divided into two areas: Traditional commodities traded on exchanges, and non-traditional or new markets, which are only accessible via indirect investments such as equities. Despite the great variations between the individual commodities, all of their markets are determined by supply and demand. Since they have a relatively low level of correlation with traditional investments such as stocks or bonds, commodities can improve the risk-return profile of a traditional portfolio.

Commodities prices are influenced by the following factors:

- Performance in the areas of economic growth, interest rates, and inflation
- Changes in inventory or availability
- Developments with regard to the transaction currency and trade regulations
- Weather conditions, natural catastrophes, and climatic change
- Geopolitical risks

Your Needs

- You want to invest in an asset that has a tangible underlying
- You want to diversify your portfolio in order to improve the risk-return profile
- You want to hedge against inflation
- You want direct exposure to global economic growth
- You are looking for investment opportunities beyond traditional stocks and bonds

Your Benefits

- Direct exposure to global economic growth
- Both the returns and risks involved in commodities are largely independent of those of bonds and equities. This makes it possible to improve the return-risk profile.
- Commodities can be used to hedge against inflation, currency, and geopolitical risks
- Gold plays an important role when it comes to diversification in times of volatile and uncertain markets
- There is no counterparty risk involved in investments that are physically deposited

Your Risks

- Commodity investments may be subject to major fluctuations in value
- The cyclical nature of commodities may impact the portfolio
- Possible counterparty risk involved in certain forms of investment
- Prices react to interest rate changes and fluctuations in the foreign exchange market
- Investments in futures or OTC derivatives may result in higher margin calls if the derivative performs poorly
- Physical settlement may result in high costs
- Liquidity may be limited under extreme market conditions
- A lack of transparency can be a problem in certain commodity markets, making analysis difficult

Commodities as an Investment Option

Commodities are natural resources that are produced from mining (e.g. precious metals and industrial metals), drilling (e.g. oil or gas), or agriculture (e.g. corn or cotton). Commodities are traded daily on futures markets around the world. Their long-term correlation with stocks and bonds is low because they have their own cycles and influencing factors. Commodities are often used as a tool to hedge against inflation.

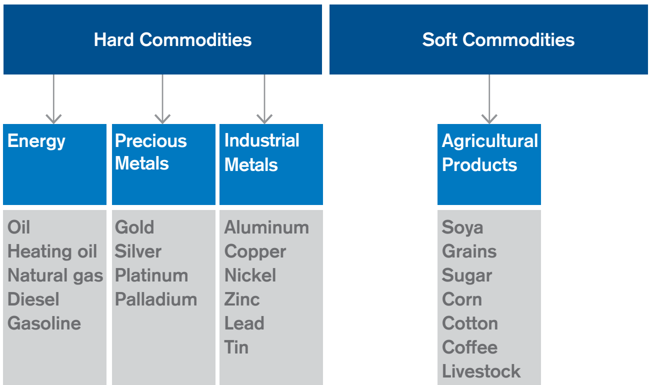
Important: Please note that the explanations in small print on page 4 also apply to this page.

Because commodities are generally traded in US dollars, they also offer a certain level of protection against phases of weakness in the dollar. Precious metals also have a special role to play here because they are traded in a similar way to currency pairs. Commodity investments offer a high level of potential for diversification and are a good way to reduce the overall risk within a portfolio, without having to accept long-term losses in your potential returns.

Commodities may be roughly divided into two categories: traditional markets and non-traditional, or new, markets.

- Traditional commodities are traded on exchanges within standardized contracts and are directly accessible to investors. These include all of the markets listed in Figure 1.

Figure 1: Commodity Categories



Source: Credit Suisse.

- New commodities are generally either not publicly traded or only illiquid contracts exist. These commodities are normally traded directly by means of contracts between various contracting parties. This means that they are usually accessible only through the purchase of shares in the companies involved. These include, for example, iron ore, coal, alternative energies, and diamonds.

Characteristics and Categories

Commodity prices are determined primarily by supply and demand. In simplified terms, commodity prices rise with scarcity, whereas a surplus results in falling prices. The prices of soft commodities also depend on weather conditions. Hard commodities, however, depend more on the business cycle. At the same time, seasonal effects play an important role in all markets. For example, the demand for heating oil rises sharply in the winter, while agricultural markets are dependent on seeding and harvesting cycles.

Energy – Energy commodities such as oil and natural gas are used to generate energy and chemical raw materials. Global energy consumption has more than doubled in the last 40 years. Oil remains one of the most important energy sources. Over 50% of global oil reserves are located in the Middle East, which is therefore a major exporter of oil, while the US and China are significant importers. Energy is highly dependent on global economic growth but is also sensitive to geopolitical events.

Precious metals – Gold, silver, platinum and palladium are the most important precious metals. Regarding the demand for precious metals, a distinction is made between the physical demand (industry and the jewelry trade) and the demand for precious metals as an investment (investor demand). The physical demand depends above all on economic growth, while investor demand is based on interest rate developments, currency fluctuations (mainly the US dollar because of the high trade volume in US dollars), and the level of inflation. In addition, gold is an attractive investment in times of market uncertainty, although it must mentioned here that even gold does not offer complete protection in times when the economy is under pressure from debt.

Industrial metals – Aluminum, copper, nickel, zinc, lead and tin are well-known industrial metals. Industrial metals, which are also known as base metals, are non-ferrous metals. Their main applications are in highly cyclical economic sectors such as the automotive, aviation, and construction industries. Early economic indicators are therefore crucial in the development of prices. China is the main consumer of industrial metals, meaning that Chinese economic data also plays an important role. Industrial metals are therefore very cyclical in nature and are the commodities that offer the most direct way of investing in China's economic growth and development.

Soft Commodities – Unlike fossil commodities, agricultural commodities are renewable. These include grains such as corn, wheat, and soybeans, cooking oil/oil seeds such as soy and palm oil, and other plants/fibers such as sugar or cotton. The prices are formed from the interaction between supply and demand. If the demand outstrips the supply, it becomes necessary to fall back on inventories. This means that prices typically rise as availability of a commodity decreases, especially if reserves are tight. Most agricultural commodities are products that meet basic needs and are therefore less dependent on economic growth than other cyclical commodities. Because agricultural commodities are renewable, the price cycles are typically shorter than for hard commodities. The prices of agricultural commodities are also dependent on the weather conditions and the availability of water.

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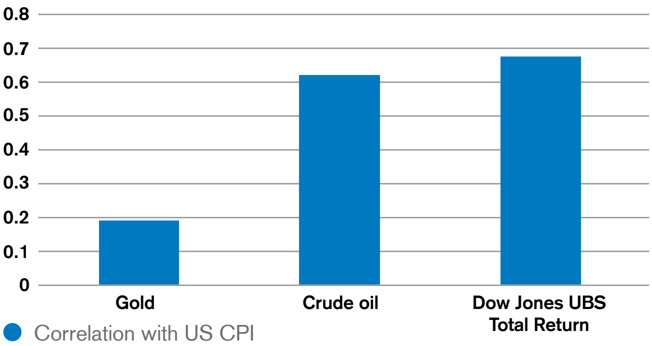
Commodities in a Portfolio Context

The advantages to your portfolio of investing in commodities

- **Commodities are an opportunity to invest global economic growth** – Industrial metals and the energy markets are of particular importance to industrial production.
- **Protection against inflation** – Commodities are input factors in important consumer goods. As a result, they play a major role in the consumer price index and can be used as protection against inflation (see Figure 2). Based on experience, gold, for example, makes less sense as a hedge against inflation, but is very promising in the longer term.

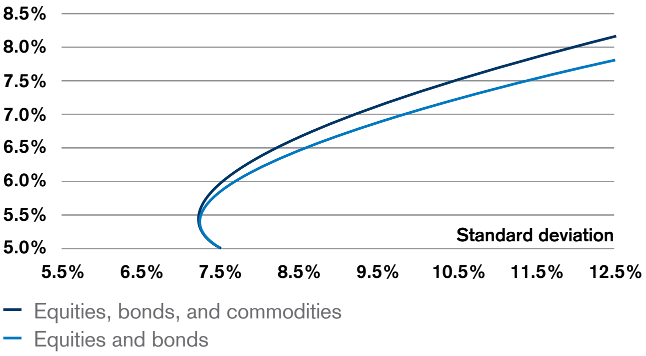
Figure 2: Correlation
Correlation based on monthly returns since 2000



Source: Credit Suisse

- **Diversification** – Commodities have their own cycles and influencing factors and their performance may therefore diverge from equities and bonds. Investments in commodities can therefore be used in order to improve the risk-return profile of an existing portfolio (see Figure 3).

Figure 3: Risk-Return Profile
Annual expected return (%)



Source: Credit Suisse

How much should I allocate to commodities?

Credit Suisse advises investing a total of 5% in commodities, with 2.5% in various commodity markets and 2.5% in gold (applies to all investment strategies).

Differences between commodities and traditional investment categories

In contrast to traditional investment categories, investors holding commodity futures have no claim to future cash flows such as dividends or earnings. Instead, investors must pay for the storage and financing of commodities until delivery. Historical analysis shows that long term returns from commodities are similar to those of equities.

Ways to Invest in Commodity Markets

1. Spot (cash transaction)

The physical commodity is bought on the spot, i.e. the investor receives the commodity immediately in exchange for cash. Private investors can perform cash transactions in precious metals like gold, silver, platinum, and palladium. In general, this is not possible for other commodities.

2. Futures

A common form of investment in commodities is futures, which are exchange-listed and standardized contracts for the delivery of a specific quantity of a commodity at a specific location, on a certain date, and at a specified price. Futures are derivatives, and investors first of all need to open a margin account in order to be able to trade in them. In addition, futures positions must be actively monitored because they need to be closed before maturity in order to prevent an unwanted physical delivery.

3. Index products

Index products bundle several commodities futures, with a wide range of products and strategies available. The benchmark indexes generally follow a buy-and-hold strategy and hold futures in all commodity sectors. Besides the changes in the spot rate, the roll yields and the interest income have an impact on the index performance. Roll yields and losses are incurred when contracts have to be sold before their maturity dates and the earnings are reinvested in new contracts.

4. Structured products

Structured products provide access to commodity markets for investors who are not willing or able to open margin accounts. In commodities trading by a bank, commodity derivatives are traded and investable products are structured for private clients. The counterparty of the private investor is the issuing bank. These products are available for a whole variety of underlyings and may contain barriers or other clauses.

5. Funds/exchange traded funds/exchange traded commodities

Fund managers invest the resources they have gathered from investors across the entire commodities sector in accordance with the fund prospectus. For example, they invest in commodity futures, funds, and also in stocks issued by commodityproducing companies. There are also funds with physically deposited commodities and therefore involve no counterparty risk. Fund performance depends on the investment skill of the fund manager and the restrictions stated in the fund prospectus. Exchange traded funds (ETFs) are investment funds that are listed on an exchange and are traded in the same way as equities. Most ETFs are index funds that replicate an equity or bond index. Exchange traded commodities (ETCs) are also listed on an exchange. They provide a cost-effective way of investing in physical commodities or in a commodity index based on at least one commodity.

6. Equities

Investing directly in equities from commodity-producing companies makes it possible to invest indirectly in commodities that are difficult to access. The development of the share price can deviate significantly from the performance of the underlying commodity.

Recommendations for Investing in Commodities

- A broadly-based commodity portfolio including futures, indexes, funds, and equities offers optimal diversification.
- A high concentration of investment volume in individual commodities should be avoided because of the high levels of volatility and risk.

Contact Us

We will be happy to arrange a personal consultation.
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