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Retirees: Look Before You Leap Into Commodities

By Christine Benz | 02-25-10 | 06:00 AM | E-mail Article

Treasury Inflation-Protected Securities are, in my view, the most efficient way for retirees to directly address the long-term corrosive effects that inflation can have on their portfolios and, in turn, their buying power. In recent articles I've addressed how much retirees should hold in TIPS, as well as how to think about the timing of a TIPS purchase. TIPS' prices can occasionally get ahead of themselves, and like most bonds, TIPS will be vulnerable in a rising-interest-rate environment. But if you're looking for a straightforward, low-cost way to hedge against inflation, TIPS are a decent way to go about it.

Many investors have also been adding commodities to their inflation-fighting toolkits, particularly as commodity-tracking investments have become more widely available in recent years. The basic case for these investments is pretty intuitive: If prices for stuff trend up, the commodities fund or ETF gives you a chance to participate in those gains. Those gains, in turn, partially offset the dent you put in your wallet as you shell out ever-higher amounts for food, gas, and so on. There's also a body of research showing that, in addition to their inflation-fighting abilities, commodities can improve a portfolio's risk/reward characteristics because of their historically low correlations with the stock and bond markets. (Those correlations appear to have increased in recent years, however.)

Most strategic (and by that I mean long-term and hands-off versus tactical and market-timing) asset-allocation frameworks that include commodities don't use huge slugs of them. Morningstar's Lifetime Allocation Indexes, for example, include midsingle-digit stakes in commodities for investors at most life stages. That's in acknowledgment of the fact that commodities as stand-alone investments can be terribly volatile, buffeted by the cyclicality of real demand for commodities as well as, increasingly, speculation. The largest commodity fund in existence, PIMCO Commodity Real Return Strategy (PCRAX), has a three-year standard deviation of about 30. For a bit of context, that's less volatile than the typical emerging-markets equity fund. However, it's about 50% more volatile than a total U.S. stock market index fund and more than 3 times as volatile as the average TIPS fund.

There's also the not-insignificant issue that unless you're prepared to take physical delivery of some ears of corn or barrels of oil, most available commodities investments are an imprecise measure of actual commodities prices. That's a problem that my colleague Paul Justice explored in this superb article, and this phenomenon could get even worse if interest in commodities investments continues to pick up.

But even if retirees accept the idea that they need to keep their commodities investments to a small part of a diversified portfolio, and that funds investing in commodity futures won't track actual prices with any sort of precision, I still worry about implementation. I also think there's a troublesome mismatch with the investment itself and the problem it's aiming to solve (inflation), particularly for retirees whose time horizons may be shorter than a couple of decades.

We could talk all day about what inflation is apt to be like during the coming decades, with some arguing for sky-high inflation because of demand from emerging markets and others opining that stagnant prices are here to stay. But under normal circumstances here in the United States, inflation charts a slow but steady course, ranging from 0% (2009) to more than 5% (1990) during the past few decades, as measured by the Consumer Price Index.

But say you had the misfortune of buying a commodities investment at the wrong time, as many investors did when they glommed onto commodities funds in the first half of 2008. You could lose 50% or more of your money right out of the box. (Commodity bulls would argue that the same is true of many domestic- and international-stock investments, but you generally hold those positions to provide growth over the long term. A strategic position in a commodities investment, by contrast, is there to protect your purchasing power on a year-by-year basis.)

And if your time horizon was only 10 or 20 years, as is the case with many retirees, you may not have a realistic expectation of recouping what you'd lost during your lifetime, let alone obtaining any future inflation protection on a year-to-year basis. There's also the not-insignificant possibility that you'd be so spooked by your losses that you'd sell your commodities investment at the bottom, thereby ruling out your participation in a rebound.

For all of these reasons, I have a hard time getting excited about commodities investments in retiree portfolios, particularly in the wake of the generally strong performance these investments have enjoyed during the past year. If you're speculating on commodities or gold with money you can afford to lose, that's different. (Not advisable, but different!) But if you're a retiree thinking about commodities as a long-term hedge against inflation, go slowly, if you go at all.

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Christine Benz is Morningstar's director of personal finance and author of *30-Minute Money Solutions: A Step-by-Step Guide to Managing Your Finances* and the *Morningstar Guide to Mutual Funds: 5-Star Strategies for Success*. Follow Christine on Twitter: @christine_benz and on Facebook.