

Commodities – Speculation or Investment?

On a regular basis, I read a number of investment periodicals and go to various conferences. Among my objectives is to learn more about what other investors are doing. I am not looking for any herds to follow or hot ideas. But, I never know when I might run across an idea that merits further study and contemplation.

The most puzzling investment practice that I see is the inclusion of commodities in otherwise diversified portfolios of stocks and bonds. By commodities I mean physical goods: raw inputs to the production process such as steel, gold, oil and cattle. The problem I have with buying commodities is simply stated: Commodities are not investments, they are speculations. Speculations are never better than mildly informed guesses.

An investment involves giving your hard-earned cash to someone else, who uses it in some productive activity of commerce or manufacturing. You take the risk that they will turn a profit and repay your money, plus a share of the profits, to you. Stocks and bonds are investments. The key part of this definition is the fact that the money is put to some productive, value-producing enterprise. The purpose might fail of course, and you are taking some risk. But nonetheless, the underlying enterprise is intended to produce cash flow in excess of the amount spent setting up the enterprise. Ultimately, *the return on your investment is dependent on the talents and skills of some other person.*

A speculation, on the other hand, involves no inherent productive process. An example is a lottery ticket. You put your money on a given number, and it either comes up or it doesn't. There is no reason to expect that a share of the profits will flow to you, because there are not any profits to be shared. The chance of your number coming up is not affected in any way by the talents or skills of some other person.

Commodities are simple speculations. What should we rationally expect to earn on commodities? Several hundred years of data is available for many commodities, and a few thousand years of data is available for one commodity – gold. We should expect that, over time, commodities prices will only grow at the rate of inflation. After all, they are simple inputs to production and produce no inherent profits in and of themselves. *Over time, we should expect an inflation-adjusted return of zero on commodities.*

Adjusted for inflation, gold is today at the same price it was at the time of the first Christmas. In over two thousand years, gold has delivered a net real return of zero.

If you buy gold, how will you earn a positive return? Gold doesn't engage in some sort of income-producing enterprise; it just sits there and we hope the price goes up. The price will go up if more people suddenly want it. That

might happen, and it might not. But, we know one thing for sure: There is no reason to expect it will happen in the way we expect General Electric or Microsoft to turn a profit. A key characteristic of a speculation is that, for you to make money, someone else has to come along and pay more for it than you did.

Some investors attempt to guess the price movements of commodities by analyzing the economy. However, this practice has little in common with the process of selecting stocks or bonds to buy. When buying stocks and bonds for the long run, we have every reason to believe that the company will be profitable and will pay us a positive return. We expect to make money whether there is inflation or not, since our money is being put to work in a productive enterprise.

Individual stocks can occasionally cross into speculative territory. Some of the dot-com companies of the late 1990s had such extreme valuations that it would have been literally impossible for the company to ever earn sufficient profits to reward its shareholders. Investors buying these stocks were merely speculating that someone else would come along and pay more for the stock than they did.

While we find it easy to chuckle and nod at such foolishness, I would encourage you to think of commodity investing the same way. A commodity buyer is merely speculating that someone else will come along and pay more for the item than they did. Whether this is a sound strategy or not is anybody's guess. One thing is certain, however. It is not investing.