Buy the Stocks?
Or, Buy the Commodities?

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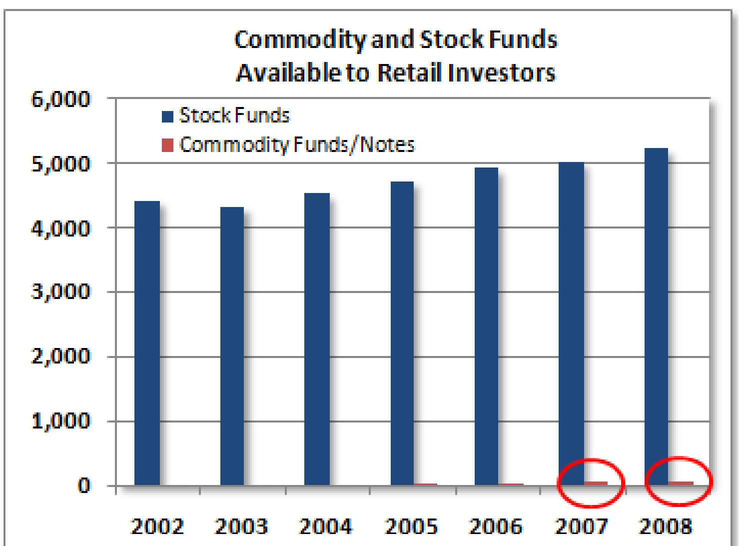
Presented at the:

An Essential Asset Class

The idea of buying commodities remains a foreign concept to many investors accustomed to buying only stocks and bonds – it shouldn't be.

Though volatile, commodities have equaled or exceeded the investment returns of stocks and bonds over the last four decades. They are an essential part of a well diversified investment portfolio, yet relatively few individual investors have chosen to add commodities to their investment mix, opting instead to buy related equities or limiting their commodity investments to small amounts of gold and silver bullion.

A growing number or mutual funds, exchange traded funds, and exchange traded notes now allow individuals to invest in commodities – more than 75 at last count– but their numbers pale in comparison to the thousands of stock and bond funds that have been offered for many years.



Investing in commodities remains far from mainstream thinking today even though, by most accounts, we are only about half way through a very long-term bull market in natural resources that is likely to last well into the next decade.

Numerous studies in recent years have proven the merits of investing directly in oil, gold, copper, corn, and other commodities– **endowment funds at Harvard and Yale have made this an integral part of the their investment approach** for some time now and pension funds in California, Pennsylvania, and elsewhere have poured billions of dollars into this asset class over the last few years.

The historical performance of commodities and their proven diversification benefits for investment portfolios of all kinds make them one of the best (and most overlooked) asset classes in recent years.

Owning both stocks and commodities makes more sense today than ever before.

I OWN A COMMODITY FUND

Some people may think that they own commodities when in fact they own natural resources stocks. Ask a 30-year old stockbroker to set you up with an investment portfolio soundly based on natural resources and you're likely to get lots of stocks but perhaps no energy, metals, or agricultural products at all.

There is still an entrenched, almost industry-wide dislike for this sector, in large part a result of the last bull market having come to a painful conclusion in the early 1980s.

> *"I have been on the street for over 20 years and I know to stay away from commodities"*

For many investment professionals and individual investors alike, it is not easy to change the way they have been taught to think after a long-running bull market in stocks. Investors and analysts are often quick to dismiss the idea of investing in commodities out-of-hand.

While institutional investors have long had access to private, index-based commodity funds and many hedge funds have traded futures on commodity exchanges, at the height of the last bull market in stocks in 2000, there was only one product available to retail investors to invest in commodities.

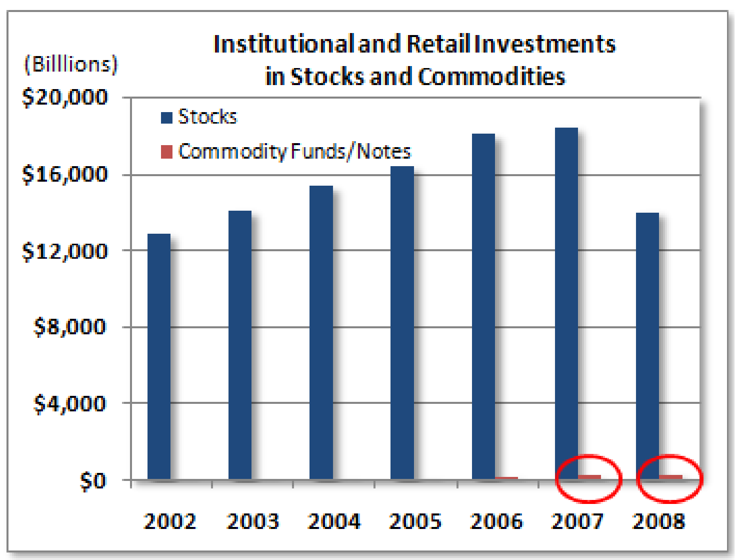
It wasn't until 2003 when Pimco launched their **Commodity Real Return Strategy Fund (PCRCX)** that investing in this sector became more practical and affordable. This family of funds, based on the broad Dow Jones-AIG Commodity Index, now holds $7 billion in assets.

Since then, dozens of investment products have entered the market, notably the **SPDR Gold Shares ETF (GLD)** in late-2004 – the first U.S. based ETF (exchange traded fund) to hold gold bullion. ETF shares trade on exchanges just like stocks and, in just four years, the trust has amassed gold holdings that would place it in the top ten largest holders of gold bullion in the world.

While it may seem that investing in commodities has gone mainstream – recent milestones of $147 oil and $1,030 gold blamed on "speculators" and "investors" alike – it is anything but mainstream.

The amount of money currently directed toward energy, metals, and agricultural products is **but a fraction of the money invested in stocks.**

While some analysts cite inflows of tens of billions of dollars into this sector as one of the causes of the recent "bursting of the commodities bubble", this amount is likely to be just the beginning as an increasing number of individuals seek ways to diversify their portfolios and boost their investment returns.

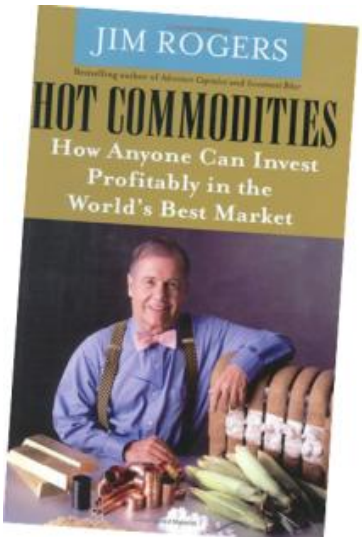


Ask a neighbor or co-worker how much money they have invested in natural gas or wheat. That is, not **Valero** or **Monsanto**, but natural gas futures or wheat futures through a commodities exchange or an exchange traded fund.

The answer you will likely get is zero.

Why Commodities Now?

One of the first to recognize the beginning of the bull market in commodities was Jim Rogers, an American investor and financial commentator who made millions as the co-founder, along with George Soros, of the Quantum Fund in the 1970s.



In 1999, recognizing that U.S. equity markets were in the process of completing a very long bull market run, Rogers created a new commodity index known today as the **Rogers International Commodities Index (RICI)**.

It's hard to imagine that anyone could have had the foresight to start a commodity fund at the height of the internet stock market bubble, but, in the long-tradition of value investing, buying low once again produced tremendous investment gains for those willing to "go against the crowd".

Eschewing Cisco Systems and Amazon.com in 1999 to buy oil at $15 a barrel and copper at 50 cents a pound was certainly "going against the crowd".

A few years later, Rogers wrote **"Hot Commodities"**, a primer on investing in this sector that urged readers to "open their mind" – to look past the inherent volatility in hard asset investments to the gains that were likely to be ahead.

The developments of the 1980s and 1990s had created great supply/demand imbalances that exist to this day and these imbalances continue to push prices upward.

Raging inflation and soaring commodity prices in the 1970s prompted renewed investment by businesses which then resulted in production surpluses in the 1980s for most commodities causing prices to collapse.

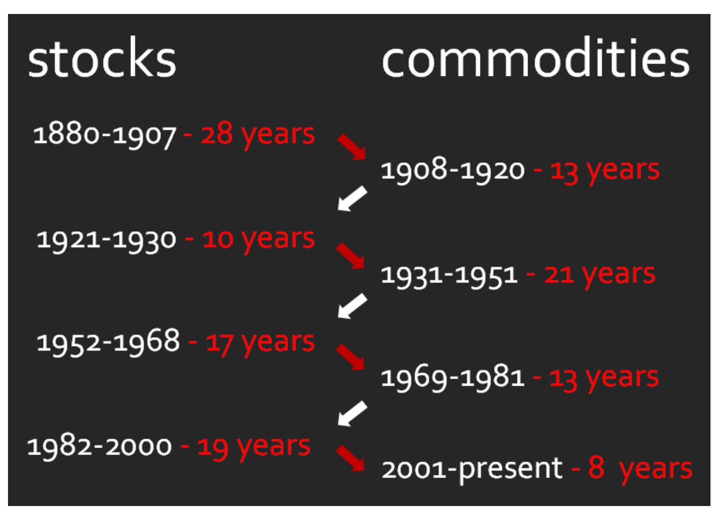
After a booming oil industry in Texas and huge increases in mine production in the West, markets became saturated with new low-cost supply.

However, this didn't happen overnight.

It took more than a decade for increased production to catch up to rising prices – the business of bringing new supplies of oil and metals online is capital intensive and requires years of hard work and investment.

Boom-bust cycles like these have repeated regularly for more than a hundred years.

Barry Bannister, an analyst at financial firm Legg Mason, identified many commodity boom/bust cycles over more than 100 years that, not coincidentally, alternated with stock market boom/bust cycles – they averaged 18 years each.

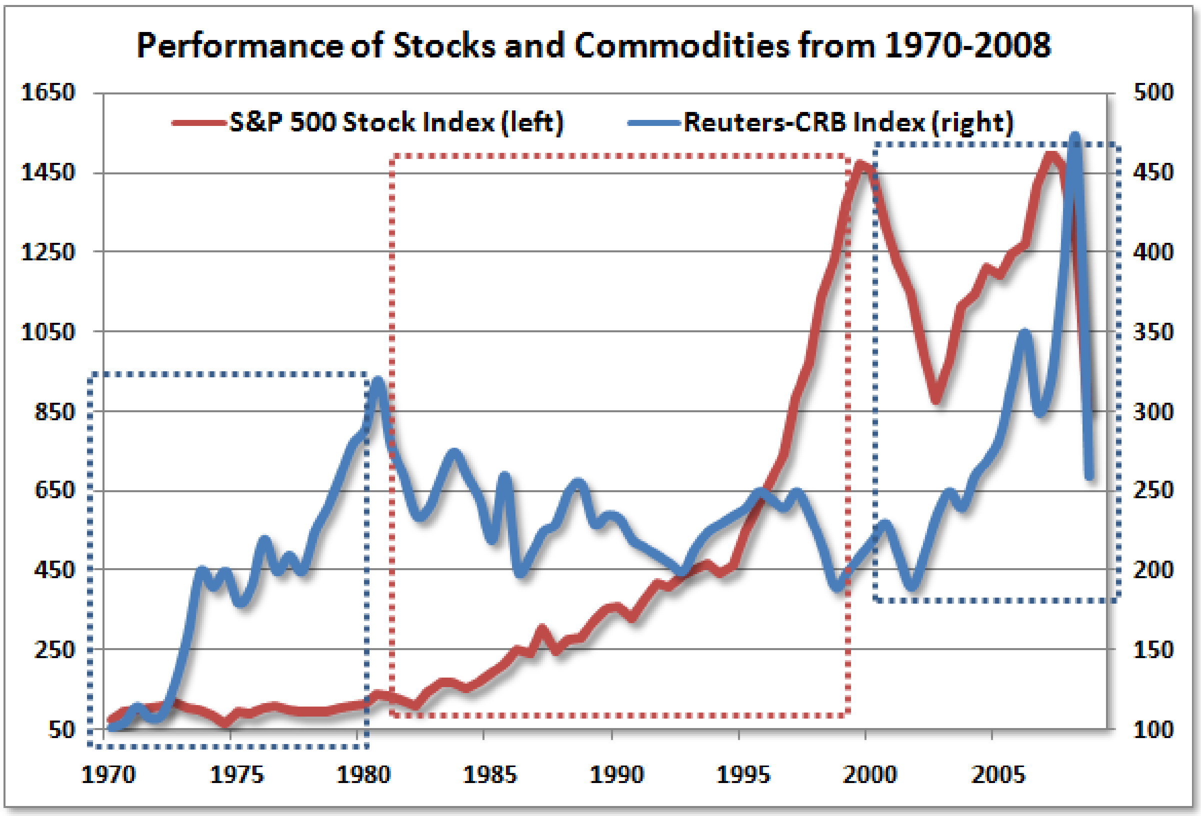


A key reason for this relationship between stocks and commodities is that **high raw material costs pressure the bottom lines of many companies** and, as everyone knows, the most important factor in determining the price of a stock is the bottom line.

HISTORICAL PERFORMANCE

A close look at the Reuters-CRB commodity index and the S&P500 stock index over the last 37 years clearly shows the relationship between stocks and commodities.

While the relationship between stocks and commodities is not quite as strong today as in previous decades due to the movement away from a manufacturing economy in the U.S. toward one based more on services, high commodity prices still impact profitability to a large degree.



While commodity prices soared in the 1970s, stock prices suffered, moving down in inflation-adjusted terms for many years.

After the oil price had peaked in 1980 at about $40 a barrel ($115 in today's dollars) and gold reached a peak of $850 (almost $2,400 today), **commodity prices fell for more than 20 years!**

With lower inflation and cheaper raw materials, businesses of all sizes had "the wind at their back" as the late 20th century bull market in stocks progressed for two full decades, ending with the late-1990s technology boom that went decidedly bust to usher in the new millennium.

Rising fuel costs pressure the bottom lines of airlines as they move business travelers and the trucking industry must either raise prices or accept lower profits when delivering foreign made goods.

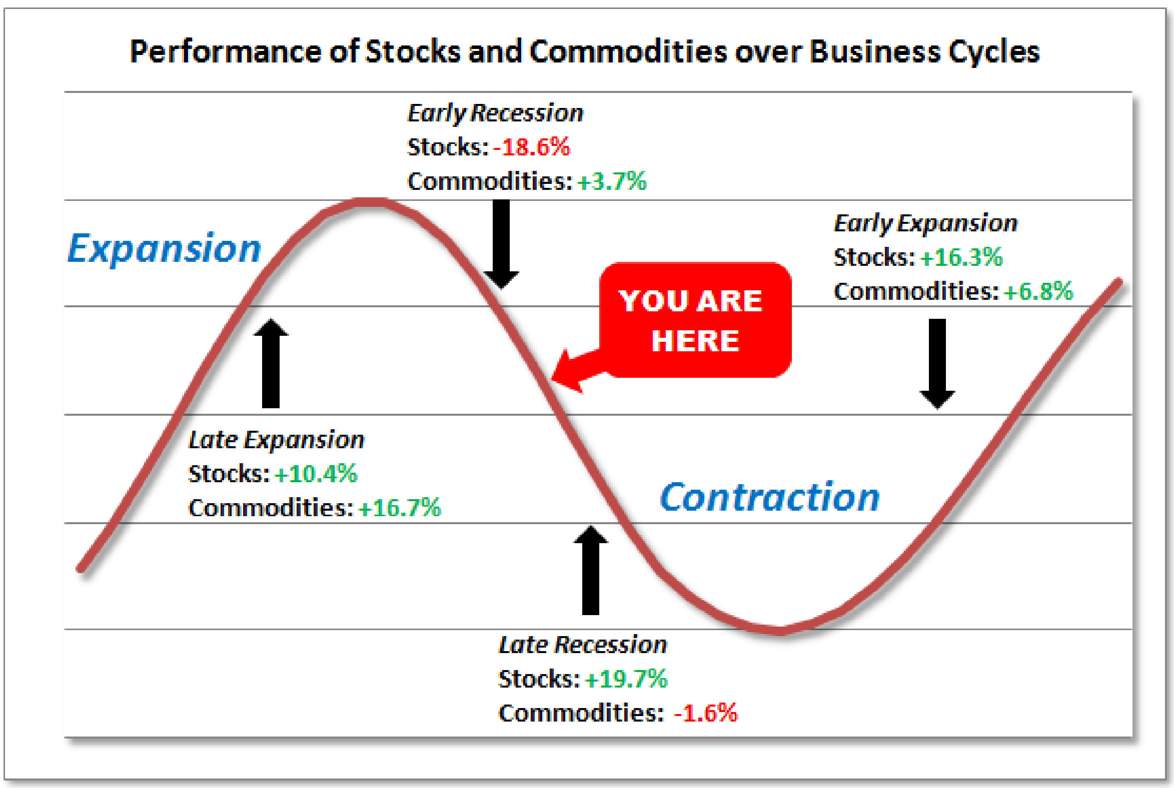
Higher food and energy costs result in wage pressures for the U.S. "service economy" as both workers and unions seek to keep pace with rising consumer prices, whether or not those rising prices show up in the government's increasingly dubious inflation statistics.

The U.S. economy has become less energy-intensive and less affected by rising commodity prices, however, they still have a very important, if under-appreciated, impact on stock prices.

The important point to remember here is that **stocks and commodities are negatively correlated** and, as such, commodities provide an effective means to diversify investment portfolios that, today, are largely based on equities.

THE BUSINESS CYCLE

Another important finding in recent studies has been the effect of business cycles on the performance of these two asset classes.



A report released in 2004 by the Yale International Center for Finance titled **"Facts and Fantasies about Commodity Futures"** clearly showed the relationship between economic cycles and investment performance.

Commodities were found to perform exceptionally well during the late stages of expansions and the early stages of recessions, providing returns far in excess of equities during both periods. Of particular importance today is the average decline of 18.6 percent per year for equities during the early stages of a recession.

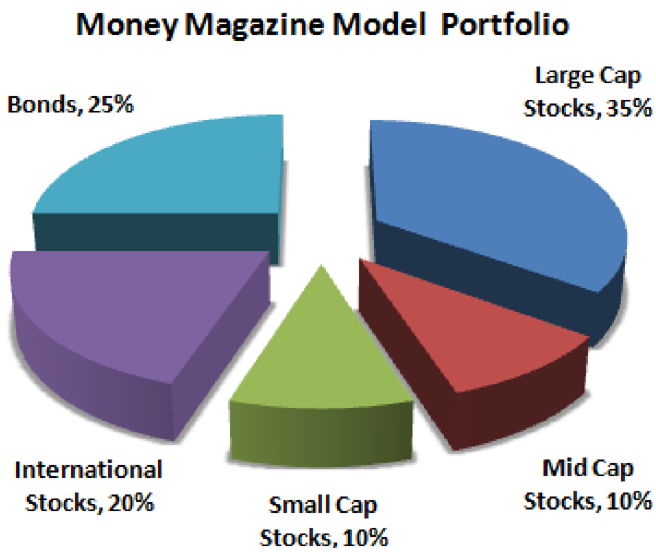
Late in recessions, the roles are reversed and stocks begin to outperform commodities, this relationship continuing through the early stages of the next expansion as equity markets "see" into the future forecasting improved earnings.

Combining the two factors discussed previously in this section – the current long-term commodity bull market and the performance of commodities over business cycles – makes a powerful case for why the prices of oil, metals, and agricultural products have risen so dramatically in the last year.

More importantly, the possibility of a prolonged recession, as many are now predicting due to the excesses that must be wrung out of the system and the long-awaited slowdown in consumer spending, **has important implications for any investment portfolio based on natural resources.**

Critical Asset Allocation

Asset allocation is a subject that gets far too little attention from most investors, but that should not be the case. Some take their cues from personal finance publications such as Money Magazine.



Now, there are many things to like about Money Magazine, but their unwavering dedication to equities as the only important asset class is not one of them.

The nation's most popular personal finance magazine provides great advice on everything from managing debt to remodeling your home, but **when it comes to your investments, they are very much in the "stocks and bonds only" camp.**

Like most investors, they prefer to stick with the prevailing "conventional wisdom" of a permanently high asset allocation for equities. Of course, that may have a lot to do with making their advertisers happy, many of whom are big retirement and investment fund companies who also believe that it's a "stocks and bonds only" world.

With the commodity bull market now in its eighth year, it will be interesting to see if and/or when any personal finance magazines whole-heartedly recommend commodities or when 401k plans see fit to include them as an investment option.

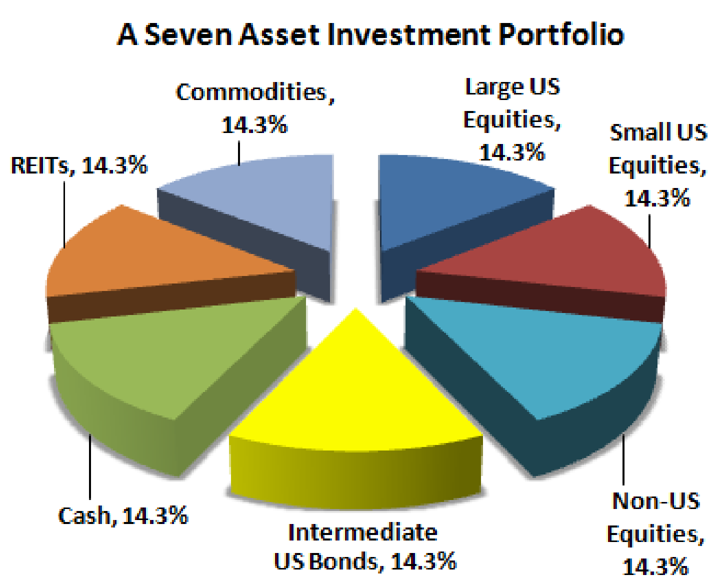
In the past, retirement plan participants have clamored for new investment sectors or classes that are only provided after prices have been rising for some time. This was the case for "growth" stock funds in the late 1990s and then for foreign stock funds a few years later.

This could also happen for commodities as well in the years ahead, adding to overall demand.

A SEVEN ASSET INVESTMENT PORTFOLIO

A 2007 study by Dr. Craig Israelsen at BYU took on the subject of conventional wisdom as it is applied to asset allocation and came up with a remarkable discovery using five, six, and seven asset portfolios with data going back 37 years.

In his paper **"The Benefits of Low Correlation",** Dr. Israelsen found that, by adding REITs (Real Estate Investment Trusts) to a five-asset "stocks and bonds only" portfolio, returns were boosted while year-to-year volatility was reduced.



the effect of adding commodities

Rate of Return: from 10.4% to 11.3%

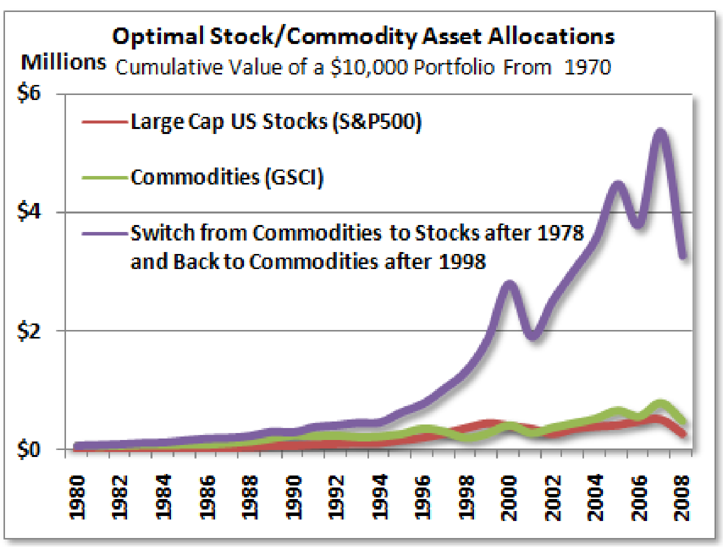
Worst Year: from -18.9% to -10.2%

A bigger surprise came when commodities were added as the seventh and final asset class – annual gains rose even further and the worst year performance improved from -19 percent to a much more manageable -10 percent.

At Iacono Research, this was taken one step further in an attempt to answer the question of what might happen if an investor switched back and forth between a "commodities only" investment portfolio and a "stocks only" approach during the corresponding bull markets for each of the two asset classes.

An even more surprising result was found.

Starting in 1970, a $10,000 investment would have grown **to over $5 million before the recent decline with just two simple changes** – switching from commodities to stocks after 1978 and from stocks back to commodities 20 years later.

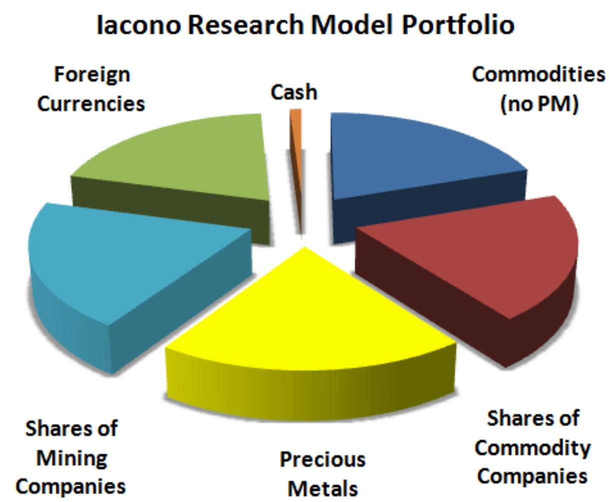


Astonishingly, neither the "commodities only" nor the "stocks only" portfolios would have ever cracked the $1 million mark.

As shown in the chart above, the 32 percent decline in commodities during 2001 and the even larger one this year would likely have been too much for most investors to bear – all the more reason for a more diversified portfolio.

A FIVE ASSET INVESTMENT PORTFOLIO

After years of looking at the question of asset allocation, a simple investment portfolio with five asset classes was developed which later formed the basis of the current "model portfolio" at Iacono Research. The equally weighted five categories, as originally conceived, are as shown below.



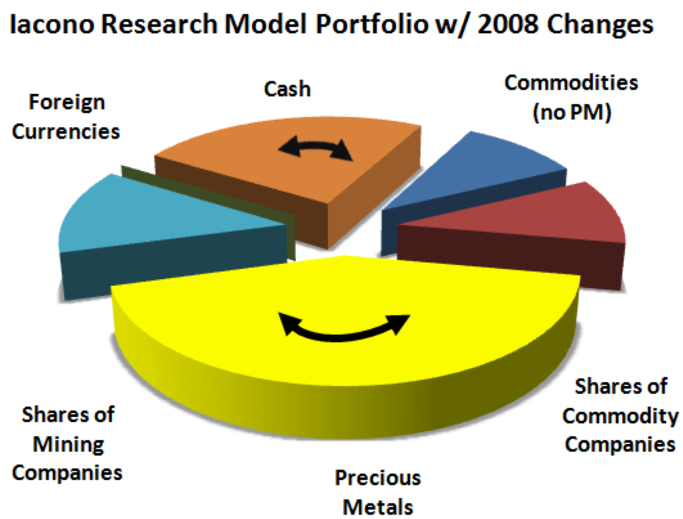
Commodities (with no precious metals) and precious metals made up the "commodities" portion of the investment portfolio contributing 40 percent of the overall total.

Shares of "commodity companies" (firms engaged in energy, agriculture, and base metal work) along with shares of "mining companies" (gold and silver only) accounted for another 20 percent each and foreign currencies rounded out the list.

Note that precious metals –the commodities *and* the related shares – were separated from other asset classes not only because they are considered "special asset classes", but also because they often move independently from the others, doing so for seven years between 1997 and 2003.

So, given the tendencies for broad equity markets to weaken and for commodities to gain early in recessions, what changes might have been made to the model portfolio in 2008?

Responding to recent conditions, the changes shown below were executed earlier this year.



Note the increases for both the cash and precious metals categories while all other categories were reduced, the foreign currencies category exited completely. While the large allocation to precious metals and cash has not eliminated an overall decline in value, it has reduced the amount of the loss.

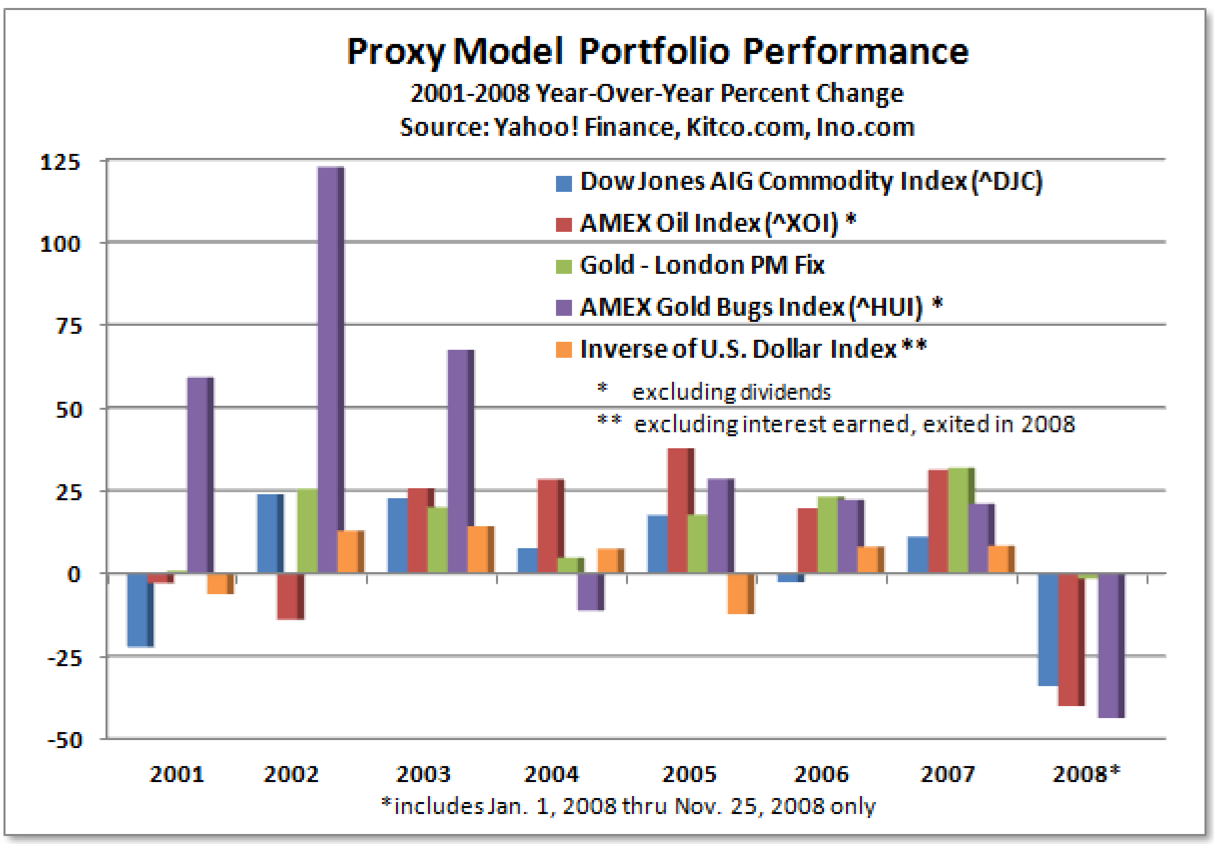
THE FIVE CATEGORIES OVER TIME

Using proxies for all five (now four) model portfolio categories as shown below, it is easy to see how these categories have performed over time, the commodity price often times moving in a different direction than the price of related stocks.

For example, gold bullion is about even this year but mining stocks (as represented by the HUI Gold Bugs Index) have tumbled.

While foreign currencies have seen modest gains in most years, the world's oldest currency (gold) is the only category to post consistent gains over the last eight years, lending some credence to the notion that an "all-gold portfolio" at the turn of the century would have been a wise choice.

Lastly note that commodities (as represented by the DJ-AIG Commodity Index) and related shares (as represented by the AMEX Oil and Gas Index) can move in different directions and that mining and energy stocks do not always move together.

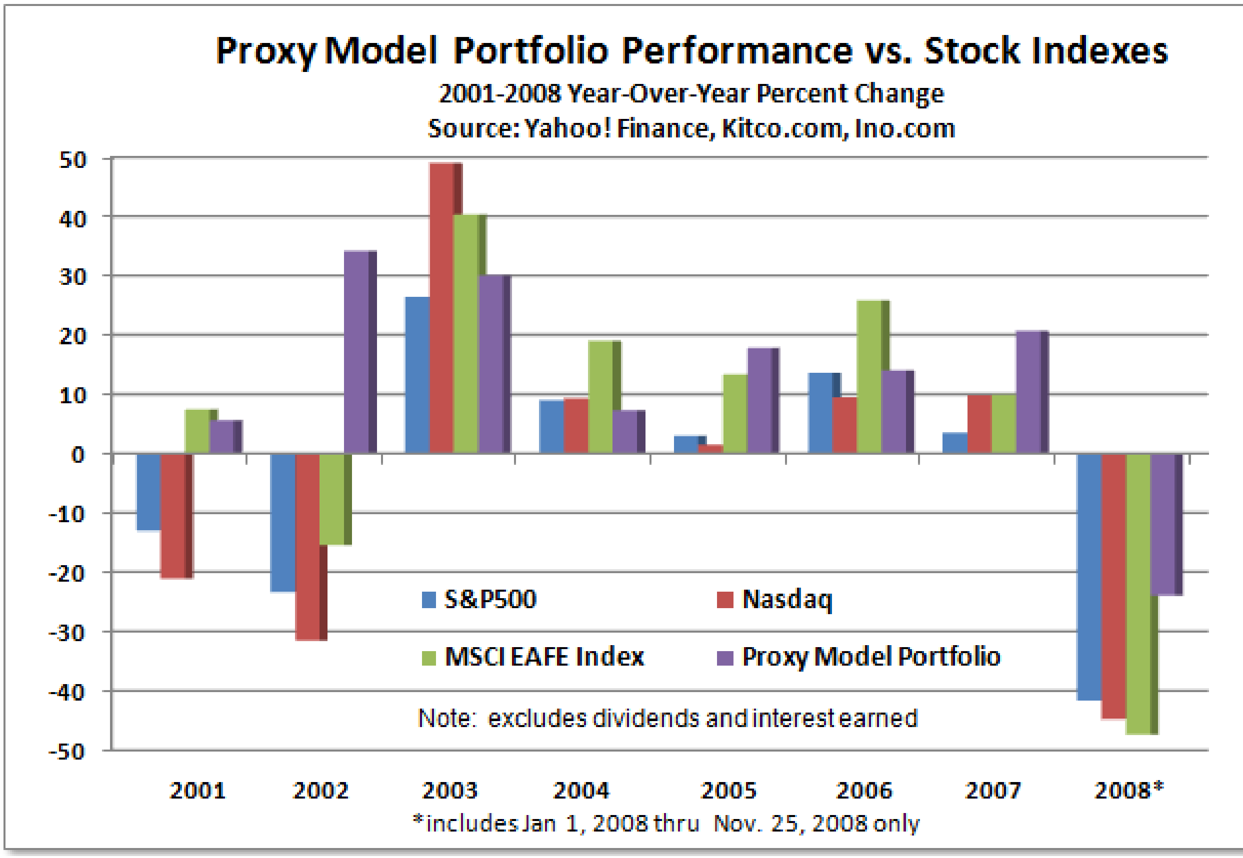


More important than what is *in* the model portfolio is what *is not* in it. By *excluding* 90% of S&P500 stocks, the worst of the early-decade and recent stock market declines were avoided.

Laying the proxy model portfolio performance up against other equity market indexes over the last eight years yields a surprising result – until the recent sell off, not a single year of losses during the entire decade.

There are two final points to consider, both of which are very important.

First, the performance shown below uses simple indexes rather than a more selective approach. Actual model portfolio performance at Iacono Research has consistently outperformed the proxy performance in the chart by five to ten percentage points per year since detailed records have been kept starting in late 2004.



Consecutive gains of 6, 34, 30, 7, 18, 14, and 21 percent are seen through 2007 with a loss of 24 percent through mid-November of 2008.

A 2001 investment of $10,000 in the four groups above would have produced the following results:

- **S&P500:** $6,491 **–36%**
- **Nasdaq:** $5,926 **–41%**
- **MSCI EAFE:** $12,515 **+25%**
- **Model Portfolio:** $24,416 **+144%**

Second, this investment approach would have performed horribly during most of the 80s and 90s and will perform horribly again someday. Understanding the major commodity/stock bull market cycles is critical to being successful.

In summary, **commodities are an essential part of a well diversified investment portfolio.** For a variety of reasons, they have been overlooked by far too many investors, but this is slowly changing and, yes, there is still plenty of time left to participate in this bull market.

Exchange Traded Funds and Notes for Commodities

Symbol	Index Based Funds	Launched	Holdings	Assets	Average Volume	YTD Gain (11/25/08)
PCRCX	Pimco Commodity Real Return Fund	Mar 2003	DJ-AIG	$6.7B	N/A	-46.2%
DBC	PowerShares DB Commodity Index Tracking Fund ETF	Feb 2006	DB-LCI	$1.3B	900K	-28.6%
GSG	iShares GSCI Commodity-Indexed Trust ETF	Jul 2006	GSCI	$485M	280K	-40.2%
GSP	iPath S&P GSCI Total Return Index ETN	Sep 2006	GSCI	N/A	64K	-41.6%
DJP	iPath Dow Jones-AIG Commodity Index Total Return ETN	Oct 2006	DJ-AIG	N/A	552K	-34.6%
RJI	ELEMENTS Rogers Intl Commodity ETN	Oct 2007	RICI	N/A	174K	-38.9%
GSC	GS Connect S&P GSCI Enhanced ETN	Dec 2007	GSCI	N/A	22K	-38.7%
GCC	GreenHaven Continuous Commodity Index ETF	Jan 2008	CRB	N/A	17K	N/A
UCI	E-TRACS UBS Bloomberg CMCI Index ETN	Apr 2008	CMCI	N/A	4K	N/A
DPU	PowerShares DB Commodity Long ETN	May 2008	DB-LCI	N/A	1K	N/A
DEE	PowerShares DB Commodity Double Short ETN	May 2008	DB-LCI	N/A	64K	N/A
DYY	PowerShares DB Commodity Double Long ETN	May 2008	DB-LCI	N/A	15K	N/A

Symbol	Energy	Launched	Holdings	Assets	Average Volume	YTD Gain (11/25/08)
USO	United States Oil Fund, LP ETF	Apr 2006	Crude Oil	$800M	12.2M	-45.4%
OIL	iPath S&P GSCI Crude Oil Total Return ETN	Oct 2006	Crude Oil	N/A	583K	-47.2%
DBE	PowerShares DB Energy Fund ETF	Jan 2007	Oil, Heating Oil, Gas, Nat. Gas	$45M	50K	-34.5%
DBO	PowerShares DB Oil Fund ETF	Jan 2007	Crude Oil	$49M	96K	-37.4%
UNG	United States Natural Gas Fund, LP ETF	Apr 2007	Natural Gas	$788M	6.3M	-26.3%
RJN	ELEMENTS Rogers Intl Commodity Energy ETN	Oct 2007	Oil, Heating Oil, Gas, Nat. Gas	N/A	28K	-45.6%
JJE	iPath DJ-AIG Energy Total Return ETN	Oct 2007	Oil, Heating Oil, Gas, Nat. Gas	N/A	6K	-39.3%
GAZ	iPath DJ-AIG Natural Gas Total Return ETN	Oct 2007	Natural Gas	N/A	42K	-29.1%
USL	United States 12 Month Oil Fund, LP ETF	Dec 2007	Crude Oil	$4M	2K	-36.0%
UGA	United States Gasoline Fund, LP ETF	Apr 2008	Gasoline	$9M	34K	N/A
UHN	United States Heating Oil Fund, LP ETF	Apr 2008	Heating Oil	N/A	4K	N/A
UBN	E-TRACS UBS Bloomberg CMCI Energy Index ETN	Apr 2008	Oil, Heating Oil, Gas, Nat. Gas	N/A	1K	N/A
DXO	PowerShares DB Crude Oil Double Long ETN	Jun 2008	Crude Oil	N/A	1.0M	N/A
DTO	PowerShares DB Crude Oil Double Short ETN	Jun 2008	Crude Oil	N/A	800K	N/A
OLO	PowerShares DB Crude Oil Long ETN	Jul 2008	Crude Oil	N/A	4K	N/A
SZO	PowerShares DB Crude Oil Short ETN	Jul 2008	Crude Oil	N/A	7K	N/A
UOY	MacroShares $100 Oil Up ETF	Jul 2008	Crude Oil	N/A	13K	N/A
DOY	MacroShares $100 Oil Down ETF	Jul 2008	Crude Oil	N/A	23K	N/A

Symbol	Metals	Launched	Holdings	Assets	Average Volume	YTD Gain (11/25/08)
GLD	streetTRACKS Gold Shares ETF	Nov 2004	Gold	$17.6B	18.1M	-1.9%
IAU	iShares COMEX Gold Trust ETF	Jan 2005	Gold	$1.5B	701K	-1.9%
SLV	iShares Silver Trust ETF	Apr 2006	Silver	$2.0B	7.1M	-30.7%
DBP	PowerShares DB Precious Metals Fund ETF	Jan 2007	Gold, Silver	$69M	50K	-9.9%
DGL	PowerShares DB Gold Fund ETF	Jan 2007	Gold	$43M	96K	-3.8%
DBS	PowerShares DB Silver Fund ETF	Jan 2007	Silver	$28M	83K	-32.1%
DBB	PowerShares DB Base Metals Fund ETF	Jan 2007	Aluminum, Zinc, Copper	$43M	72K	-38.0%
RJZ	ELEMENTS Rogers International Commodity Metal ETN	Oct 2007	Various	N/A	31K	-35.1%
JJC	iPath DJ-AIG Copper Total Return ETN	Oct 2007	Copper	N/A	9K	-45.6%
JJM	iPath DJ-AIG Industrial Metals Total Return ETN	Oct 2007	Aluminum, Zinc, Copper, Nickel	N/A	3K	-42.3%
JJN	iPath DJ-AIG Nickel Total Return ETN	Oct 2007	Nickel	N/A	8K	-60.5%
DGZ	Deutsche Bank Gold Short ETN	Feb 2008	Gold	N/A	26K	N/A
DZZ	Deutsche Bank Gold Double Short ETN	Feb 2008	Gold	N/A	761K	N/A
DGP	Deutsche Bank Gold Double Long ETN	Feb 2008	Gold	N/A	2.2M	N/A
PMY	MLCX Precious Metals ELEMENTS ETN	Apr 2008	Gold, Silver, Platinum, Palladium	N/A	2K	N/A
GOE	MLCX Gold ELEMENTS ETN	Apr 2008	Gold	N/A	<1K	N/A
UBG	E-TRACS UBS Bloomberg CMCI Gold Total Return Index ETN	Apr 2008	Gold	N/A	<1K	N/A
USV	E-TRACS UBS Bloomberg CMCI Silver Total Return Index ETN	Apr 2008	Silver	N/A	<1K	N/A
UBM	E-TRACS UBS Bloomberg CMCI Industrial Metals Index ETN	Apr 2008	Aluminum, Zinc, Copper	N/A	2K	N/A
PTM	E-TRACS UBS Bloomberg Long Platinum ETN	May 2008	Platinum	N/A	10K	N/A
PTD	E-TRACS UBS Bloomberg Short Platinum ETN	May 2008	Platinum	N/A	2K	N/A
BDD	PowerShares DB Base Metals Double Long ETN	Jul 2008	Aluminum, Zinc, Copper	N/A	4K	N/A
BOM	PowerShares DB Base Metals Double Short ETN	Jul 2008	Aluminum, Zinc, Copper	N/A	17K	N/A
JJT	iPath DJ-AIG Tin Total Return Sub-Index ETN	Jul 2008	Tin	N/A	1K	N/A
JJU	iPath DJ-AIG Aluminum Total ReturnSub-Index ETN	Jul 2008	Aluminum	N/A	1K	N/A
LD	iPath DJ-AIG Lead Total Return Sub-Index ETN	Jul 2008	Lead	N/A	4K	N/A
PGM	iPath DJ-AIG Platinum Total ReturnSub-Index ETN	Jul 2008	Platinum	N/A	6K	N/A
PGM	iPath DJ-AIG Platinum Total ReturnSub-Index ETN	Jul 2008	Platinum	N/A	5K	N/A

Symbol	Agriculture	Launched	Holdings	Assets	Average Volume	YTD Gain (11/25/08)
DBA	PowerShares DB Agriculture Fund ETF	Jan 2007	Corn, Wheat, Soybeans, Sugar	$1.2B	1.5M	-25.2%
RJA	ELEMENTS Rogers Intl Commodity Agriculture ETN	Oct 2007	Various	N/A	230K	-35.1%
JJA	iPath Dow Jones AIG Agriculture Total Return ETN	Oct 2007	Various	N/A	28K	-32.8%
JJG	iPath Dow Jones AIG Grains Total Return ETN	Oct 2007	Corn, Wheat, Soybeans	N/A	41K	-33.7%
COW	iPath Dow Jones AIG Livestock Total Return ETN	Oct 2007	Live Cattle, Lean Hogs	N/A	100K	-26.9%
LSO	MLCX Livestock ELEMENTS ETN	Apr 2008	Cattle, Hogs	N/A	4K	N/A
UAG	E-TRACS UBS Bloomberg CMCI Agriculture Index ETN	Apr 2008	Various	N/A	1K	N/A
FUD	E-TRACS UBS Bloomberg CMCI Food Index ETN	Apr 2008	Various	N/A	2K	N/A
UBC	E-TRACS UBS Bloomberg CMCI Livestock Index ETN	Apr 2008	Live Cattle, Lean Hogs	N/A	2K	N/A
FUE	MLCX Biofuels Index ELEMENTS ETN	Apr 2008	Various	N/A	3K	N/A
GRU	MLCX Grains Index ELEMENTS ETN	Apr 2008	Corn, Wheat, Soybeans, Soy Meal	N/A	4K	N/A
DAG	PowerShares DB Agriculture Double Long ETN	Apr 2008	Corn, Wheat, Soybeans, Sugar	N/A	52K	N/A
AGA	PowerShares DB Agriculture Double Short ETN	Apr 2008	Corn, Wheat, Soybeans, Sugar	N/A	32K	N/A
JJS	iPath DJ-AIG Softs Total ReturnSub-Index ETN	Jul 2008	Coffee, Sugar, Cotton	N/A	1K	N/A
JO	iPath DJ-AIG Coffee Total ReturnSub-Index ETN	Jul 2008	Coffee	N/A	2K	N/A
SGG	iPath DJ-AIG Sugar Total Return Sub-Index ETN	Jul 2008	Sugar	N/A	3K	N/A
BAL	iPath DJ-AIG Cotton Total Return Sub-Index ETN	Jul 2008	Cotton	N/A	7K	N/A