THE Equity View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

Doug Sandler, CFA • Sam Turner, CMT • Paul Louie • Chris Konstantinos December 17, 2009

Commodities Survival Guide

An Essential "How To" Primer For Investors

In the most recent *Strategic View,* Chief Investment Officer Michael Jones reiterated RiverFront's recommendation for maintaining a significant allocation to commodities within a diversified portfolio. For investors who have little experience with commodity investing, this is something that is often easier said than done. Today, we wanted to tackle this problem with a quick "How To" primer for the commodity investing novices. *Buying commodities allows for a source of diversification for those sophisticated persons who wish to add this asset class to their portfolios and who are prepared to assume the risks inherent in the commodities market. Any commodity purchase represents a transaction in a non-income-producing asset and is highly speculative. Therefore, commodities should not represent a significant portion of an individual's portfolio.*

What does a Diversified Commodity Allocation Look Like?
"Commodities" can mean different things to different people; therefore, it is important to have a benchmark to guide allocation decisions. We believe the Dow Jones-UBS Commodity Index[1] is the most appropriate benchmark for diversified investors. We chose this index because it has maintained the most consistent exposure to its underlying constituents, unlike many other commodity indexes that are often hijacked by a single constituent, such as Energy. The primary components and their percentage weightings of the Dow Jones-UBS Index are presented in Table 1.

Table 1

Commodity Class	Constituents	Allocation (11/30/09)
Energy	Gasoline, Natural Gas, Heating Oil	32%
Industrial Metals	Copper, Aluminum, Lead	25%
Agriculture	Corn, Wheat, Livestock, Coffee	30%
Precious Metals	Gold, Silver	13%
Total		100%

Implementation Strategy
In our view, a diversified commodity portfolio should include representation from each of the four major commodity classes: Energy, Industrial Metals, Agriculture, and Precious Metals. We recommend building this allocation through a core/satellite approach; the core of the portfolio is comprised of a broadly diversified commodity vehicle, and satellite positions are added when alpha[2] opportunities present themselves.

Implementation Vehicles
Most investors are uncomfortable buying commodities in a traditional sense (via commodity futures) due to their high minimums, potential delivery requirements, and investment restrictions. Outside of the futures market, the exchange-traded product market offers the next best vehicle for implementation, in our view. Although very similar, we believe there are several advantages and disadvantages to both exchange-traded funds (ETFs) and exchange-traded notes (ETNs).

- *Exchange Traded Funds:* Commodity ETFs purchase future contracts and Treasury Bills, and custody those assets at a third party (such as State Street or Bank of NY). This relationship allows the investor to assume none of the credit risk of either the ETF provider or the issuing financial entity, a major positive, in our view. The major disadvantage to accessing commodities through an ETF, however, is that it requires the issuance of a K-1 to the investor for tax reporting purposes.
- *Exchange Traded Notes:* In an ETN, there is no custody account holding the underlying assets for the investor. Instead, the ETN is essentially an "IOU" of the issuing financial institution. This structure allows the ETN issuer to avoid having to issue K-1s;

[1] *The Dow Jones AIG Commodity Index is a broadly diversified index that tracks futures contracts on physical commodities.*

[2] *Alpha measures the risk (beta) adjusted rate of return on a portfolio in excess of what would be predicted by an equilibrium model, such as the Capital Asset Pricing Model (CAPM). If two managers had the same return, but one had a lower beta, that manager would have a higher alpha. Alphas may change over time.*

however, the investor assumes the credit risk of the issuing institution (such as Deutsche Bank or Barclays). In most market environments, credit risk is not a significant concern, but when it is it can be devastating. For example, investors that purchased ETNs issued by Lehman Brothers were only able to recover pennies on the dollar despite the performance of the indices that the ETNs were designed to track.

ETF or ETN -- Our Recommendation

Given the advantages and disadvantages of each structure, we think the ETF presents a better investment solution within our portfolios. Why? We believe it is too risky to assume the credit risk of any financial institution, especially when one considers that commodities could potentially comprise 5-15% of a portfolio. While we did not have specific credit concerns regarding any issuer, we recognize how difficult it is to gauge the soundness of any financial institution with certainty and how quickly conditions can change.

Which ETF Issuer: All commodity ETFs are not created equal. Not only do the ETFs differ from the perspective of the indices they track, they also differ in their methodology of purchasing futures contracts. Many commodity ETFs are structured to purchase the "near future," which puts them at a structural disadvantage when commodity markets are in contango[3], as many are now. We chose the Deutsche Bank commodity ETFs, issued by PowerShares, because they are structured to purchase the most attractive futures contract across the entire commodities complex that optimizes the roll yield[4]. We believe this embedded flexibility allows these ETFs to best insulate an investor from negative roll yield over time.

Outlook on Commodities

- *Precious Metals:* Although our Price Matters[5] discipline suggests that gold is about 70% overvalued, previous periods of aggressive money creation have pushed gold to as much as 200% overvalued. Therefore, we remain **Overweight** precious metals due to the group's upward momentum but are diligently watching the technicals for evidence of a change in trends.
- *Industrial Metals:* We think industrial metals represent the best combination of attractive Price Matters valuation, rising global demand, reasonable supply considerations and strong relative momentum; we remain **Overweight** in our portfolios going into 2010.
- *Agriculture:* We have been cautious on agriculture commodities because they are the only commodity sector in which improving technologies have consistently lowered production costs for more than 60 years. However, agricultural commodities underperformed in 2009 and look fairly attractive on our Price Matters framework. Therefore, we remain alert for opportunities to add exposure as rising demand from emerging economies could combine with historically low inventory levels, prompting a "catch up" rally. This outlook, in our view, warrants a **Neutral** recommendation.
- *Energy:* Energy prices face potential headwinds due to changing supply and demand dynamics, but with oil at $70/barrel, which is currently in the middle of the Saudi's comfort level of $60-80/barrel, we recommend a **Neutral** allocation. Portfolio positioning should be adjusted as crude trades toward the upper or lower end of the $60-80/barrel range.

Potential Vehicles

- **Core: PowerShares DB PowerShares Commodities Index ETF (DBC-NYSEArca-$24.11)** is a broad based commodity ETF comprised of 13 of the most liquid commodity contracts. Investors in DBC gain exposure to the four major commodity classes: Energy, Base Metals, Agriculture, and Precious Metals.
- **Precious Metals**
  - **DB PowerShares Precious Metals ETF (DBP-NYSEArca-$39.23)** is an ETF representing ownership of gold (about 80%) and silver (about 20%) futures.
  - **SPDR Gold Shares (GLD-NYSEArca-$111.59)** is an ETF representing ownership of physical gold stored in a secure facility.
- **Industrial Metals: PowerShares Base Metal ETF (DBB-NYSEArca-$21.91)** is made up of equal portions of aluminum, copper and zinc futures.
- **Agriculture: PowerShares Agriculture ETF (DBA-NYSEArca-$26.70)** provides exposure to the most important areas of the agricultural complex including wheat, cattle, sugar, corn and soybeans.
- **Energy: PowerShares Energy ETF (DBE-NYSEArca-$25.02)** is made up of energy futures representing each of the four major energy commodities: crude oil, heating oil, gasoline and natural gas.

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[3] *When the price of a commodity's futures contract is above the expected future spot price.*

[4] *The increase or decrease in price that occurs when a security is rolled to a new futures contract, instead of trading in the futures contract or just letting it expire.*

[5] *RiverFront's Price Matters[SM] discipline compares inflation-adjusted current prices relative to their long-term trend to help identify extremes in valuation. For additional information see The Strategic View -- The Heart of the RiverFront Value Discipline: Dynamic Strategic Allocation (2/3/09), available at www.riverfrontig.com.*

For further information concerning the risks associated with the PowerShares DB Commodities ETFs, please visit www.powershares.com or contact your financial advisor.

Gold Risks: The price of gold has fluctuated widely over the past several years and the Shares have experienced significant price fluctuations. If gold markets continue to be subject to wide fluctuations, this may result in potential losses if an investor needs to sell his shares at a time when the price of gold is lower than it was when he made the investment. Even if an investor is able to hold the shares for the longer-term, she may never experience a profit, since gold markets have historically experienced extended periods of flat or declining prices in addition to wide fluctuations.

Oil & Gas Company Risks: Oil and gas companies develop and produce crude oil and natural gas. Stock prices for these types of companies are affected by supply and demand both for their specific product or service and for energy products in general. The price of oil and gas, exploration and production spending, government regulation, world events and economic conditions will likewise affect the performance of these companies. Securities of companies in the energy field are also subject to swift price and supply fluctuations caused by events relating to international politics, energy conservation, the success of exploration projects, and tax and other governmental regulatory policies. Oil and gas equipment and services can be significantly affected by natural disasters as well as changes in exchange rates, interest rates, government regulation, world events and economic conditions. These companies may be at risk for environmental damage claims.

For further information concerning the risks associated with the SPDR Gold Shares, please visit www.sectorspdr.com or contact the company at 1-800-THE-AMEX.

Doug Sandler, Chief Equity Officer • 804-549-4803 • dsandler@riverfrontig.com
Sam Turner, CMT, Portfolio Manager• 804-549-4808 • sturner@riverfrontig.com
Chris Konstantinos; Portfolio Risk Manager• 804-549-4810 • ckonstantinos@riverfrontig.com
Paul Louie, Portfolio Management• 804-549-4807 • plouie@riverfrontig.com
Riverfront Investment Group, 9011 Arboretum Parkway, Suite 110, Richmond, VA 23236 • www.riverfrontig.com