UWEALTH

GUIDE TO UNDERSTANDING ASSET CLASSES :

COMMODITIES

U Wealth : Your partner in mastering financial instruments.

We want you to feel comfortable making suitable investment decisions based on knowledge of the opportunities and risks of given financial instruments.

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FINANCIAL INSTRUMENTS: OPPORTUNITIES AND RISKS

The higher the complexity of a financial instrument, the higher its potential risk –but the higher, too, the opportunities for returns.

WHAT ARE COMMODITIES?

A commodity is a **marketable item or good produced.**

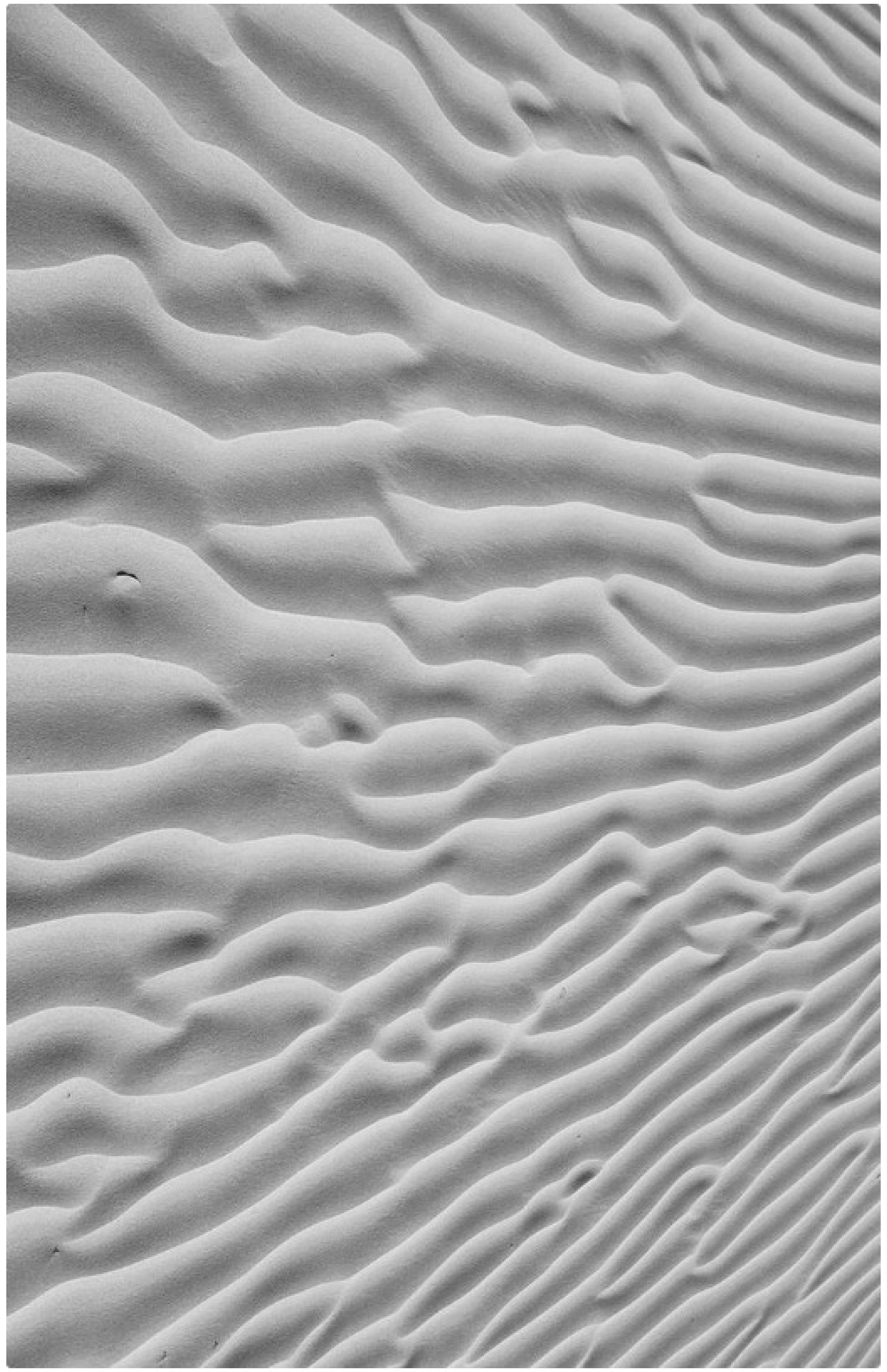
In economics, this includes all goods and services.

In finance, to be traded as a 'commodity', the goods must be

- **sufficiently standardised** (same quality for the same good) and usable upon delivery
- **traded in bulk**
- have price variations **big enough to be attractive** for investors.

Examples include:

- energy: crude oil, gas
- base metals: copper
- precious metals: gold
- agriculture: wheat
- livestock: cattle
- bulks: e.g. iron ore, coal



ADVANTAGES/DISADVANTAGES

Advantages

- Diversification: commodities respond differently to economic movements than stocks and bonds
- Protection against inflation

Disadvantages

- Cost of carrying fees (storage fees for physical reserves)
- Bid/ask spread
- Volatility

If used as a financial investment, commodities other than precious metals are usually not bought/sold directly; instead, one invests in products that have commodities as underlying assets. There are a variety of financial instruments available, such as structured products, derivatives, and mutual funds.

Such instruments bear other opportunities and risks, and investing in them requires the corresponding knowledge. Please consult the relevant U Wealth educational material for details on these instruments.

IMPORTANT RISKS TO CONSIDER

Market risks

- Commodities are highly volatile in price and depend on many factors other than supply/demand including geopolitical situation, country-specific economic factors, inflation, natural influences (e.g. climate, weather) and the nature of the commodity itself.
- Commodities respond differently to economic cycles than financial instruments like stocks and bonds.

Indirect investments

- Unless investors are interested in the goods themselves, they usually invest indirectly, using financial instruments such as futures and options that have commodities as underlying assets. Past investors have direct access to them as long in non-bulk quantities.
- Investors who forget to close a long position of a future before expiry will receive physical delivery of the commodity.

WHAT TO EXPECT FROM COMMODITIES

Investment horizon

- Short term
- Medium term
- Long term

Income expectation

- Capital gain

Market expectation

- Increasing
- Decreasing
- Sideways
- High volatility

The investment horizon and the income and market expectations are entirely dependent on the financial product chosen.

IMPORTANT TO KNOW BEFORE INVESTING IN COMMODITIES

Maximum gain

Unlimited: any capital gain realised minus bid/ask spread

Maximum loss

Total loss of capital invested

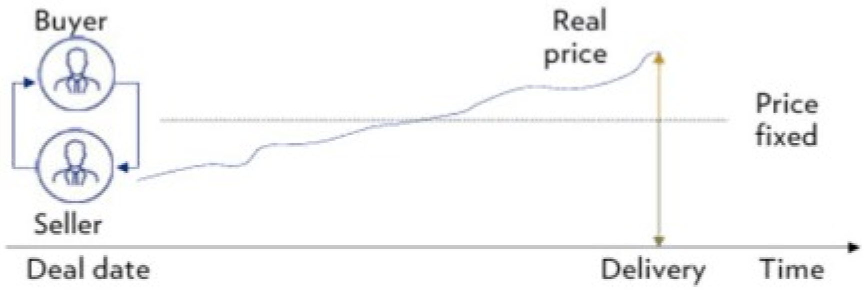
Profit/loss

Revenues on commodities are difficult to estimate. In making your investment decisions, consider the following points:

- the market value of commodities responds differently to changes in the global economic environment and traditional instruments. This can be an advantage as much as a risk.
- commodities are more volatile than other financial instruments. Being physical goods and basically raw materials, they are often directly linked to regional or global industrial supply/demand.
- investing in commodities that have collective value and prices, such as coins or gemstones, can lead to price volatility and subjective valuation.
- the supply/demand equality of the commodity may be an issue.
- if physical commodities must be safely and correctly stored.

A CLOSER LOOK AT COMMODITIES

HOW COMMODITIES WORK

Example	Characteristics	Motivations
Spot market 	• Goods against cash • Contracts based on daily prices • Bulk quantities	• Buyer and seller have a direct interest in the good itself (e.g. airlines buying oil).
Future / forward exchange 	• Standardised financial agreements • Agreement to buy/sell in the future at a price fixed today • Bulk quantities	• Direct interest in the good combined with an insurance • Purely financial interests as insurance or speculation
Retail business by banks 	• Physical delivery against cash • Retail quantities • Bid/ask spread	• Financial interests (e.g. in the case of gold)

DIRECT AND INDIRECT TRADING OF COMMODITIES

For investors who have no interest in trading the physical good itself, there are two options for trading commodities.

Indirect

Indirect: trading a financial product that has a commodity as an underlying

- **Futures, forwards, options, and structured products:** these are advanced financial instruments with very specific properties and risks. Investing in these instruments requires the corresponding knowledge. Please consult the relevant U Wealth educational material on these instruments.
- **Mutual funds:** funds are collective investments that pool money from a number of clients for common investment. Funds are available for any type of investment. Risks and properties vary and a basic knowledge of funds is required.

Direct

Direct: buying and selling precious metals

- **Precious metal account:** this is similar to holding foreign currencies.
- **Physical delivery:** buying and selling the physical items, e.g. bars, coins. In order to protect the investor, they are usually kept in custody with a bank and custody fees apply.

COMMODITY INDICES

When investing indirectly in commodities, corresponding products (e.g. funds) are often based on commodity indices or commodity futures due to their advantages regarding accessibility and traceability.

There are a number of available indices that track the commodity markets. These indices differ in their composition (component weights) and roll strategies.

Composition and component weights

Determination of which components (e.g. agriculture, oil, wheat) are included in the index, and in what ratio.

For example, a product based on the index may be used to reflect trends towards production economies and liquidity.

Roll strategies

The investment strategies do not track commodity spot prices directly but rather future prices. Futures are shorter-term investments that are rolled over when the investment term ends.

Upon rollover, there are costs and gains. The roll strategy determines which investment terms and costs are calculated in the index.

MAIN RISKS ASSOCIATED WITH COMMODITY INVESTMENTS

When you invest in commodities, you are usually exposed to **two categories of risk.**

Commodity market risky

- Commodity prices are highly volatile.
- The reasons for changes in commodity prices are not always clear to investors.
- Commodities are not equally distributed globally; instead, different commodities are found in different regions and countries. Inflation, etc. carry different risks, e.g. agricultural goods are exposed to adverse climatic conditions. Therefore, commodity prices are not merely a function of supply and demand. They are also a function of natural, geopolitical, country-specific, and economic factors.
- Commodities are the basis for other products, and they respond differently to the economic cycle and to other financial instruments (e.g. stocks and bonds).

Financial product risk

- Private investors do not stand to directly receive commodities.
- Investments therefore carry specific risks and rewards of the financial product chosen to hop, e.g. structured product or derivative. Such investments can also offer diversification of the commodity market risks, as well as adding new risks through the mechanics of the product itself.
- Investments are made in a financial form, the risks are those of the risks carried by the product plus any risk that the index may carry (e.g. a tracking error).
- Investors who forget to close a long position of a future before expiry will receive physical delivery of the commodity (if they have not agreed on cash settlement only).

FOR FURTHER INFORMATION ON RISKS OR ON OTHER AVAILABLE FINANCIAL INSTRUMENTS, PLEASE REQUEST TO YOUR RELATIONSHIP MANAGER ON U WEALTH EDUCATIONAL MATERIAL.

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U Wealth SA – 8C avenue de Champel, 1206 Genève, Suisse Supervised by FINMA (Swiss Financial Market Supervisory Authority)

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