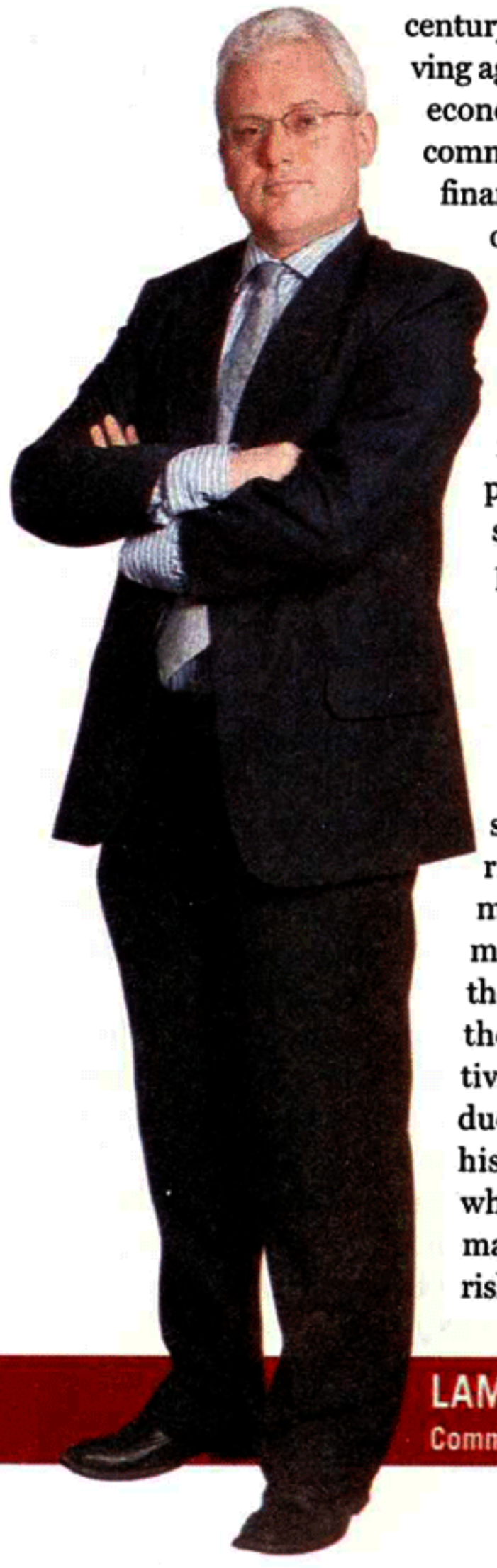
WHERE TO INVEST IN 2010-11 commodities

Investing In The Future

Futures markets provide a costless mechanism for risk transfer

COMMODITY derivatives are not for investment. They are risk management tools like insurance and price discovery utilities. India was among the first to introduce an organised commodity futures exchange in the 19th century. Exchanges flourished in the country for over half-a-century until they were closed as part of economic controls during World War II. Afterwards, exchanges faced a tough time, and languished while international exchanges continued striding ahead. It was only in the early years of the 21st century that policy conditions started improving again. With the modernisation of India's economy, the door was opened for modern commodity exchanges, alongside other new financial risk management and investment options in the equity and debt space.



The newly permitted national commodity exchanges (set up in 2003) quickly made up for lost ground. Metal and energy contracts, both as risk management tools for those exposed to global price volatility in these sectors, and as investment vehicles for people keen to diversify from the equity market, have become popular.

Whereas previously only a handful of the largest companies had access to global risk management markets, futures contracts have helped thousands of smaller firms transfer their risk in an efficient manner. Futures markets provide an almost costless mechanism for risk transfer because they bring together various segments of the marketplace with differing objectives and price outlooks. A copper producer, for example, may want to lock in his margin by protecting the price at which he sells, while a wire producer may want to protect himself against the risk of increasing copper prices.

A futures market allows both buyers and sellers to meet their objective; the exchange guarantees all trades that take part on its platform. Both can trust their contracts' sanctity (note that neither producer nor consumer will use the exchange for physical delivery, rather they use it as a risk transfer tool). Furthermore, the exchange permits investors to take positions based on their outlook — do they expect prices to fall or to rise?

From an investor's perspective, commodities are an asset class in their own right. As a stand-alone investment, they do no better or worse than other investments, providing similar returns for similar risk levels. But they are probably easier to understand and evaluate than other asset classes where valuation has many more subjective components. For example, copper prices reflect global supply/demand balances; the impact of a slowdown in Chinese economic growth on copper prices is easy to see. Commodity futures investments add value as part of a portfolio. Investing part of one's funds into bullion provides protection against inflation.

Commodity exchanges create more transparent markets, allow investors access to a new asset class at minimal cost, and bring economic and financial efficiencies by de-risking production, processing and trade.

An exchange should meet international best practice standards in terms of its technology, its risk management systems and its self-regulatory mechanisms. Investors should be able to trade with trust — trust that the exchange guarantees all trades, and trust that the exchange and its regulator, the Forward Markets Commission, have a wide array of safeguards in place to ensure market integrity.

While an incomplete and overdue process of regulatory reform is stymieing the contribution that India's exchanges can make to its economy — for example, India has not yet seen the reduction of storage costs that would result if investment funds and banks were permitted to take up hedged positions in metal stocks — commodity exchanges are poised to take on a larger role.

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