'It makes sense to have commodities in your portfolio'

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Commodities are outside the radar of most investors in India. In an exclusive chat with *Business Line*, Mr Lamon Rutten, Managing Director and CEO of MCX, shared some of his views on why investors should consider adding commodities to their portfolio and how they can go about doing it.

Excerpts:

The case for including commodities in investment portfolios

There are many studies globally which show that including 5 to 10 per cent of commodity in your portfolio improves the return for any given risk level. These studies were done over the past 20 years and they hold true even when commodity prices have been in secular decline.

There are couple of reasons why it makes sense to have commodities in your portfolio.

First, because it is a non-correlated asset class as by and large commodity prices don't move in the same way as other asset prices. Beyond that, commodities offer protection against inflation and foreign exchange scenarios.

The moment inflation picks up, commodity prices shoot up. If something goes really wrong with the economy, gold prices move higher. There is an inverse relationship with certain assets and commodity assets.

Taking exposure to commodities

You can invest in commodities in different ways, through security-type products like ETFs or commodity bonds but the most capital efficient way of investing in commodities is through the futures market. As the only outgo here is contract margin, you don't have to freeze your capital to build a decent exposure to commodities.

Commodity exchanges function pretty much like other financial markets. There are well organised brokers and there are guidelines available on how brokers and clients need to act.

It needs to be understood that futures price incorporates all the present information. Every time new information comes in, the price gets adjusted. Futures price is not a forecast but it says that based on information we have now, this is the most likely price, 3 months, 6 months or 1 year from now.

Getting started

Are these markets complicated? In reality, no. The modes of access are the same as in securities. You open a trading account with a broker, you give instructions, you get confirmations of your positions; all pretty straight forward.

Commodity derivatives permit you to go both long and short. So you can take positions that make you benefit from price increases and also take positions that help you benefit from price declines. It really makes sense to try to understand the underlying market so that you can take positions depending on how you view the developments in the underlying.

There are some risks investors should guard against. Clients should not fall for fixed return promises. If some broker says give your money to me for monthly income of 3 per cent or 5 per cent; that does not exist.

Understanding commodity price movement

Commodity prices are driven by supply and demand which is perfectly understandable. If you have a given supply level and then there is news that China's growth is higher than anticipated, you know that faster growth means higher growth in their investment in infrastructure and higher consumption. Faster growth in infrastructure means greater import demand for maybe copper or iron ore. Supply reacts slowly so copper and iron ore prices will go up.

On the consumption side, you know that some Chinese eat more pork, pork needs cattle-feed and cattle-feed means imports of rough soya beans that puts pressure on soya prices.

Supply demand equations determine commodity price as most commodity products have a delivery mechanism. If certain prices are too high or too low, people will make or take delivery from the exchange bringing together physical prices and futures market prices.

For our local contracts, we don't have physical settlement. Our international reference contract prices are linked to physically-settled contracts on international commodity exchanges. There is 99 per cent correlation between the above two.

Transaction costs

We have various levels of transaction cost charged by MCX depending on the volume of the broker going from Rs 1 per lakh to Rs 2.5 per lakh. The average transaction fee for the exchange is Rs 1.8 per lakh. Brokerages are very low since many brokers are aiming at rapid expansion.

Margin requirements are determined by the volatility in the commodity. So margins are higher when prices are volatile and lower when prices are stable. Maximum margin collected is 10 per cent. Standard margin is between 4 to 5 per cent.

Most traded contracts on MCX

If we consider the long-term, the top traded contract is gold. Number 2, 3, 4 is filled by either copper, silver, crude oil and so on. Right now the top-traded contract is silver because silver prices have been very volatile, of late.

Agri-commodities feature very low on the list. In absolute terms it is high but in relative terms they make up less than 2 per cent of the turnover.

The reason is two-fold. First, because the policy environment for agricultural commodities is difficult. The concern on inflation, even if it is not based on any facts, exposes exchanges and clients to policy risk. It has happened in the past when wheat futures were banned overnight making many clients and members incur huge losses. So investors have been afraid of moving in to these contracts. The other reason for low turnover is that the physical environment for agricultural products in India is very under-developed; lack of warehouses, very poor logistics and so on.

Commodity indices

MCX publishes a number of indices and they can be ideal investment instruments. Unfortunately under current regulations, trading on these indices is not yet allowed. Some amendments have to be made to the law to permit trading in indices. These amendments are more or less ready since 2005. At one time they were even notified by the government and then they were allowed to lapse. We are waiting for these amendments to be passed.

International reference contracts

Through international reference contracts such as that for copper or lead, MCX provides entrance to global markets to Indian hedgers and speculators. There is an RBI regulation that permits large companies to hedge through international exchanges such as the London Metals Exchange. They need permission from RBI, then open a credit line from a broker in London or Singapore and then execute their transaction. Smaller companies with similar price exposure can not use overseas markets. But they can use our exchange and get similar benefits. Since our contracts are settled in rupee, currency risk is also eliminated.

Proportion of hedgers and traders

It is difficult to put a number to that. In exchanges globally 50 to 60 per cent of the trades happen within one day. We are no different. This is intra-day trading and clearly not hedging. We are probably closer to 60 than 50.

As for the trades that are carried over, there are people who take longer term speculative positions and there are also hedgers. Globally it is 50:50. Since we do not have institutions operating on the exchange we have probably 40 per cent hedgers.

The gold sector uses our contracts extensively for hedging. Other sectors such as metals, jewellery and many from SME sector also use MCX for hedging their exposure.



It really makes sense to try to understand the underlying market before you take positions.

— MR LAMON RUTTEN, MANAGING DIRECTOR AND CEO OF MCX.