The Other Bull Run

As an emerging asset class, commodities hold big promise for retail investors. BY ANAND ADHIKARI



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It was a low-key launch, without much fanfare, for commodity derivatives trading on the Multi Commodity Exchange of India, or MCX, in November 2003. There were concerns in some quarters that excessive speculation in commodities would lead to price volatility. To begin with, only a dozen commodities were given the nod for derivatives trading.

Seven years later, most of these fears appear to have been unfounded and commodity derivatives trading has actually been a spectacular success story. Already, for those who want to diversify their portfolios beyond shares, bonds and real estate, commodities are emerging as the best option. Volumes on the MCX alone spurted to a record ₹8,635,705 crore in 2010. All the three commodity exchanges in India — the MCX, the National Commodity and Derivatives Exchange, or NCDEX, and the National Multi-Commodity Exchange of India, or NMCE — have electronic trading, settlement systems and a national presence. Futures trading is possible in over 100 commodities. The largest commodities bourse, MCX, today has a vast network of a 1,000-odd brokers and over one lakh trader workstations. Leading financial services groups such as Kotak, Religare, Motilal Oswal, Edelweiss and Sharekhan have entered the market or have plans to do so.

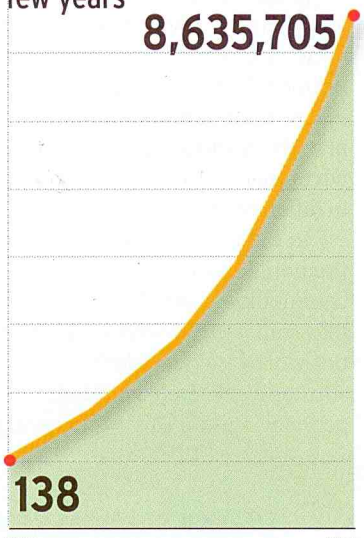
"It is a very easy market to understand," says Pritam Kumar Patnaik, Vice President, Kotak Commodity Services. The variables impacting commodities are mainly seasonal factors along with demand and supply, and global aspects. Historically, pricing in commodity futures has been less volatile compared to that in equity and bonds, thus providing an efficient portfolio diversification option. Producers of a commodity can shield themselves from price volatility by selling in futures, retail investors can add commodities to their portfolio without necessarily taking delivery, and exporters can get an indication of the likely future price, and accordingly build it into their contracts.

Commodities have given investors spectacular returns of late, and that explains their surging popularity. Silver, nickel, pepper, red chilli, crude palm oil and turmeric are among commodities that have fetched returns of between 20 per cent and 70 per cent over the past year. The reasons for this are not too difficult to understand. The rapid economic growth in India, China and Latin American countries is driving consumption of commodities — from base metals to agri commodities — and putting pressure on prices. Indeed, a number of commodities have shown a secular, long-term bull run. Consider the example of gold, which has rallied from $250 per troy ounce in 2000 to a high of $1,400 per troy ounce in 2010. In the same period, silver zoomed from $5 per troy ounce to $30 per troy ounce.

Lamon Rutten, MCX Managing Director and CEO, attributes the explosive growth in commodities

The Boom

Futures volumes have exploded in the past few years



MCX turnover in ₹crore

"Our markets could follow the global trends where commodities are two to three times equities, if regulations are relaxed"

LAMON RUTTEN, Managing Director and CEO, MCX



UMESH GOSWAMI

trading to the efficient trading platforms. Rutten, whose MCX dominates the market with an 80 per cent share in total turnover, says the corporate sector is taking a lead in hedging its risks on the commodity bourses. "The commodities boom only underlined the need for effective risk management," adds R. Ramaseshan, Managing Director and CEO of rival NCDEX. Non-agricultural commodities are more liquid where the big corporates hedge their raw material risks or play the arbitrage game by taking advantage of the price differentials in different markets.

In India, corporates account for the lion's share of the turnover in commodities, and there are others like traders, exporters and high-net-worth individuals. Retail constitutes a relatively small 20 to 25 per cent. But all this could change soon with a vibrant futures market. Retail investors can build a portfolio in commodities without having physical stocks as all the exchanges offer both options — cash and delivery mechanisms. If investors want the contract to be settled in cash, they have to indicate at the time of placing the order that they do not intend to deliver. For taking or making delivery, investors have to provide the required warehouse receipts. An overwhelming majority of the contracts, 90 to 95 per cent, are settled in cash, and for trading, margins are payable upfront to the exchanges through brokers. Margins range from 5 to 10 per cent of the value of the commodity contract, which vary from ₹16,114 (gold guinea) to ₹2,037,500 (gold 1-kg contract). So, you could actually start off trading with just ₹800.

"Commodities is a very easy market to understand... **The asset class is so large that nobody can manipulate prices"**

PRITAM PATNAIK, Vice President, Kotak Commodity Services



At present, the equities futures market in India is three times the size of commodity futures — unlike in the US and UK where commodities are more liquid than equities. But the commodity futures business in India is on a tear and analysts believe it will soon mirror the global trend where it is two to three times bigger than equities. "We could see something similar if regulations are relaxed in India," says Rutten.

Exchanges and market players argue that the growth of the commodities market has been hit by a stifling regulatory framework, particularly the bar on institutional trading by banks, mutual funds and foreign institutional investors, or FIIs. Traders also feel there is needless and excessive intervention by the authorities. In the past few years, futures trading in several commodities such as rice, wheat, soybean oil, rubber, chickpeas and potatoes has been banned for extended periods by the market regulator, the Forwards Markets Commission, to curb excessive speculation and tame inflation. Globally, too, there have been precedents where futures trading in select commodities has been restricted. For instance, trading in onion futures has been banned in the US after price manipulation by a cartel was uncovered in the 1950s.

However, experts point out that curbs on futures trading have not had much impact on inflation in most cases, in India and abroad. Instead, they adversely affected farmers and importers who were hedging their risks on the exchange platform. In 2008, a government-appointed panel chaired by economist Abhijit Sen did not recommend a ban on other food commodities, saying there was no conclusive evidence to suggest that futures trading contributed to price increases.

In the past, the government's decision to ban exports of commodities such as wheat and sugar to address domestic shortages also prevented proper price discovery in the market — as is supposed to have happened when wheat prices flared up internationally in 2008 and India banned exports.

Highly traded commodities like base metals and bullion are linked to international prices. "The asset class is so large that nobody can manipulate gold or energy prices," says Patnaik of Kotak.

Despite the obstacles, the commodities market is evolving as a promising asset class for retail investors. But, like the equity markets, investors would do well to do their homework before investing in their favourite commodities. ◆