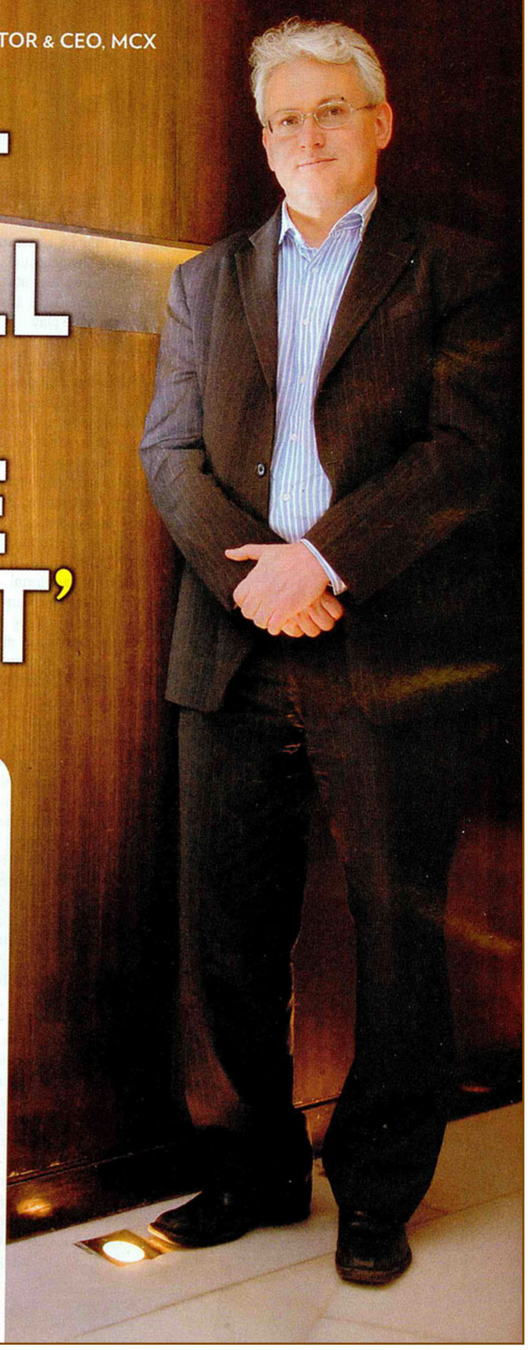
INTERVIEW
LAMON RUTTEN, MANAGING DIRECTOR & CEO, MCX

'DON'T PUT ALL EGGS IN ONE BASKET'



The managing director and CEO of Multi Commodity Exchange of India (MCX) on the importance of commodities in your portfolio, the right approach to investing in them, and their ordinary run in India so far, in a chat with Outlook Money's **Rajesh Kumar**

There has been a lot of volatility in commodity prices in recent times. Considering that, does it make sense to invest in commodities at this point?

Volatility in commodity prices has existed since there have been commodities. According to several econometric studies, the current volatility in commodities is not higher than what it has been historically.

Irrespective of whether prices go up or down, it makes sense to have commodities as part of the portfolio. This was substantiated by a very powerful study done in the 1990s, after the commodity market had been in decline for more than a decade. It simulated the impact of adding commodities to portfolios at risk levels that were set by

people who conducted the study.

The study concluded that although you would have lost money in absolute terms in commodities, even in a period of declining prices, adding commodities to the portfolio would have led to better returns. Prices go up and down, but the fact remains that commodities should be part of your portfolio. Somehow, it's sexier when prices go up. However, that is just short-term thinking, without really understanding how a portfolio should really influence your investment decision.

What should be the treatment of commodities in a portfolio, especially when it is said that prices revert to their mean?

It makes no practical sense to talk about mean reversal. So, in practice, one should not factor in this aspect. As far as the share in portfolio is concerned, it will depend on two things—risk preference and the time horizon of your investment. Normally, it's 5-20 per cent, but the exact measure will depend on one's personal risk preferences.

Commodities should account for 5-20% of a portfolio, but the exact measure depends on one's risk preference

Do commodities actually qualify as a separate asset class?

Yes, they are an asset class in the sense that they are not well correlated with other asset classes. Portfolio diversification is a subject that has been dissected—hundreds of studies have been done and all of them say the same thing. If an individual investor thinks that it does not help to have commodities in his portfolio, then he goes against the experience of these hundreds of studies. So, it is common sense to invest in commodities, but the degree of exposure depends on your risk profile.

Despite being one of the largest producers and consumers of several commodities, why hasn't investing in commodities taken off in India?

There are two problems. First, people need to learn about commodities. One should put his eggs in different baskets, but most people are not doing that. Keep in mind that in economic theory, the models behind portfolio diversification were developed only in the 1950s, and the economist got the Nobel Prize for that. So, the concept is not that simple. I am not surprised that people take time to learn it.

Second, organised institutional investors, pension funds and mutual funds are not permitted to use commodity markets. Honestly, if such entities do not invest in commodities, they are giving investors a raw deal. There are dozens of studies showing that if people invest for, say, their pension, and the pension fund aims at generating the best possible returns, the fund has to be in commodities. If pension funds are deprived of that opportunity, the pensioner gets lower pension.

The regulatory framework in India dates back to 1952 and some of its parts need to be amended. There are amendments before Parliament. If those amendments are passed, it will be the beginning of a better regulatory framework. That is, really, the key thing.

Commodities are complex and difficult to understand. Is this the reason why investing in them has not taken off in India? What is the trend in developed markets?

In the early 1980s, there was shift in Western countries from individual money managers to mutual funds. Individuals outsourced the management to specialists. So, from the late 1980s onwards, it's become more institutionalised. I doubt if commodities are more complex than stocks. Many commodities are not that difficult to understand. In case of agricultural commodities, you have the weather to make estimates. In industrial commodities, it is GDP growth. In fact, there is no way one can assess the value of a stock if he is put in isolation, even if he has access to all stock-specific data. One needs to see what's happening in the stock exchanges. Except that, there is no way to find the fair price of a company. In commodities, you can talk to passersby on the road and ask for their opinion about the weather. If they have an opinion about weather, they have one about commodity prices too.

We do not have option contracts in commodity markets in India. Why? If introduced, how will they help?

The law concerned dates back to 1952 and does not allow options. If introduced, they will be of great help. Internationally, people have switched from stop loss orders to options as the risk management tool. Stop loss orders may not be effective in a fast-moving market, but options are 100 per cent effective. So, it will help many people manage their risk better. I would strongly recommend the introduction of option contacts.

What should people avoid while investing in commodities?

Don't put all your eggs in the same basket and be as informed as you can. Often, the mistakes that investors commit are emotional, not intellectual. If people make an investment decision, they somehow start believing that it has become a part of them and they are hesitant to admit that they have committed a mistake. So, that emotional aspect has to be removed from investment decisions. ||

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