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Mutual Funds and Commodity Derivatives Markets: The India Perspective

The current reforms and liberalization of both the real and financial markets in India economy known for its commodity-intensity, makes it inevitable for the commodity derivatives market to align itself to the positive emerging changes.
The commodities derivatives market must gear itself up to meet the growing demand for risk management and commodities. Indian economy is witnessing a growing demand for commodities and risk management.

At the same time, with linkages of Indian firms with the global economy getting increasingly stronger, the ripples of any development in the global market is increasingly being felt strongly and immediately in the Indian markets too. Too often, this linkage is manifested in the volatility of prices of commodities which are widely traded. Accordingly, there is an immediate need to strengthen institutions, such as the commodity derivatives market, which can provide respite from the effects of commodity market volatility in the best possible manner. In other words, the commodity derivatives market must be strengthened for it to play its rightful role of an efficient enabler of price risk management in the current Indian economic scenario which is unfolding.

One of the important way by which the commodity derivatives market can be strengthened is by undertaking reforms which broaden and deepen the market. An important parameter that potential hedgers look at while deciding to manage commodity price risks on an exchange platform is the impact cost of trade, which is a direct function of the liquidity on the exchange. Thus, a vibrant domestic market in commodity derivatives can be created if access is provided to a large variety of participants who can, not only participate in the exchange-traded commodity derivatives market in an effective manner to manage their risks but also, by doing so, inject liquidity and lower the impact cost and make the market more cost-effective for potential hedgers. This is a virtuous cycle which needs to be created and nurtured in India's commodity derivatives market.

NEED FOR ENTRY OF FINANCIAL INSTITUTIONS

To meet the above-mentioned objective, financial institutions riding on their research strengths and capabilities would need to be permitted to trade on India's commodity derivatives market. Currently, only non-financial firms and individuals are permitted to take positions in India's commodity derivatives markets and financial institutions such as banks, mutual funds, pension funds, insurance companies and foreign investors are not allowed. The participation of these entities is essential not only for making the Indian commodity derivatives markets more robust and inclusive, but also to provide the Indian investing public more avenues for safe financial investment, portfolio diversification opportunity and risk management instruments.

One of the key financial institutions missing in India's commodity derivatives market remain the Mutual Funds that connects investible funds to investment opportunities. For a growing economy like India, it is essential to channel public savings away from physical investment and into financial instruments, something that mutual funds in India are performing. Indian Mutual Funds are performing a critical role in the equity and debt markets. By playing the role of a constructive intermediary between millions of small savers looking for safe investment instruments with higher returns and the financial markets, mutual funds have been able to channelize public savings towards these equity and debt markets to a significant degree.
Expanding the realm of operations of the mutual funds, it is desirable that they be allowed to trade in a host of other regulated markets too, such as the exchange-traded commodity derivatives market, in order to enhance access of retail investors to safe, transparent and regulated market instruments.

More investors can be brought into financial markets by improving the returns and at the same time reducing the risks to the investors' portfolios, which can be enabled by addition of commodities into the portfolios. It has been historically proven that commodities are less volatile as an asset class compared with other asset classes, while the returns are comparable,

making commodity derivatives an attractive proposition for inclusion in investors' portfolios.

BENEFITS TO MUTUAL FUNDS

A large number of retail investors wish to invest in commodities. However, due to complexity in rolling over of futures contracts, maintaining margins etc. many such long-term investors stay away from the derivatives market. Given these inconveniences, the only recourse investors seeking to earn returns on commodity price movements have is by taking an exposure indirectly, i.e. by trading in the shares of commodity producing companies or by investing in mutual funds that invest in shares of such companies, with the underlying assumption that share prices of these companies have a good correlation with the prices of the commodities they produce. When the mutual funds are allowed to launch schemes investing in commodities, a large pool of such investors can do so directly through the mutual funds route. Mutual funds can, in turn, expand their market and customer base. Besides, opening an entire asset class to these intermediaries will enable them work out different strategies and schemes in order to maximize the total returns of investors.

COMMODITIES - THE INVESTMENT OPPORTUNITY

The commodity derivatives market provides ample investment opportunities for all classes of investors, including the retail investor. The appeal of this segment as an attractive investment proposition arises due to the following reasons, which, in turn, make for a case for mutual funds to participate in this market:

Portfolio Diversification: Inclusion of commodities offers great portfolio diversification benefits as prices of commodities such as bullion have a tendency to bear low or negative correlation with those of other asset classes, such as equities, especially at times of economic upheavals. The comparison (Fig 1) clearly demonstrates the role of gold as portfolio diversifier owing to its weak and negative correlation with other asset classes. With the availability of a wide variety of gold contracts in Indian commodity derivatives market, the retail consumer, therefore, should be able to diversify their portfolio efficiently.

Fig. 1: 5-year weekly return correlation on key assets and gold (INR)



Hedge against inflation: Unlike stocks and bonds, commodities are real assets, containing intrinsic value, reflected in their prices, based on their actual commercial or industrial application. Thus, commodities' price fluctuations are more in tandem with inflation than those of other asset classes. Hence, investment in commodities can help in attaining a natural hedge against inflation. Commodity mutual funds, if allowed, would enable retail investors an opportunity to hedge their investments against inflation.

Better risk adjusted returns: Over a long period, the risk-weighted returns (RAR) from investment in the commodity derivatives market are better than those in other comparable asset classes and therefore appeals as an investment option to all classes of investors. An analysis (Fig 2) on historical price movement by clearly shows utility of commodities in an investment portfolio (in US markets). With commodities in the portfolio, not only do the returns of the portfolio improve, risks also subside substantially. Sharpe ratio, which is often used to characterize how well the return of an asset compensates the investor for the risk taken, is also higher in the portfolio with commodities as against portfolio without commodities.

BENEFITS TO COMMODITY DERIVATIVES MARKET

The entry of mutual funds in the commodity derivatives market is likely to bring in substantial benefit to this market, as well. Apart from providing access to millions of retail investors who otherwise would not be able to access the market, participation of mutual funds would provide the much-needed depth and liquidity in the market, especially in far-month contracts riding on their research mettle. Higher liquidity in far month contracts would help attract hedging interest in India's commodity derivatives market, making this risk management platform much more efficient. Besides, large scale participation of institutions with deeper professional expertise can bring in richer information, whose assimilation on the exchange platform would lead to better price discovery, ultimately increasing the robustness and public confidence in Indian traded prices. This is an important step in making India a price-maker in the global commodities market.

CONCLUDING REMARKS

Indians have traditionally invested in non-financial assets such as bullion, land, etc. Hence, the less sophisticated Indian investors can relate to and relatively easily take to investment in commodities, when looking out for a safe haven to protect the value of their investible surplus besides adding value to it. Mutual funds can tap into this opportunity to connect Indian investors to the commodity derivatives market, offer cross asset class investment products and thus help fill a key missing element in the savings portfolio of the Indian savers. By doing so, these institutions would also be complementing current policy efforts at channelizing public savings from physical to financial markets.

Fig. 2. Effects on portfolio returns and Sharpe ratios of adding commodities to portfolio: 31 August 1959, through 30 April 2009

Parameters/portfolio composition	100% equities	60% equities/ 40% bonds	80% equities / 20% commodities	80% (60% equities/ 40% bonds)/ 20% commodities
Total return	9.05%	8.45%	9.51%	8.94%
Standard deviation	15.34%	10.46%	12.86%	8.98%
Sharpe ratio	0.29	0.31	0.35	0.40

Sources: Vanguard calculations, based on Commodity Research Bureau; Datastream, Thomson Reuters