# Go the index way

## Introducing commodity indices trading will make it simpler for investors to participate in commodity markets

**V SHUNMUGAM & JAYATI MUKHERJEE**

Shunmugam is head and Mukherjee is senior analyst, Research, Multi Commodity Exchange of India (MCX)



**FINANCIAL MARKETS ARE** bound to become inclusive, and if such inclusiveness can be brought about by the availability of varied products meeting various needs of participants, it will provide for sustainable growth of markets and hence efficiency. Of various ways one could access commodities, the 'index way' stands out for its ease and ability to provide exposure to the price and performance of a given basket of commodities that are appropriately weighted. The basket may be broad-based, comprising of different types of commodities across sectors, or can consist of a few commodities that track a particular sector.

Typical of commodity derivatives, an index can also comprise of only one commodity, for example crude oil or silver. These single commodity indices help investors track the performance of the respective single commodities and compare their performance through appropriate roll over reflecting market best practices without the concerns associated with physical delivery.

Globally, commodity index-based products are available as exchange-traded products (ETPs) as well as over-the-counter (OTC) swap products. The contracts offered by exchanges allow investors to have exposure to a variety of benchmark commodity indices. These products are traded on exchange as futures contracts based on total return or excess returns. For example, SPGSCI Energy Excess Returns Future Contracts, which provide investors with a reliable and publicly available benchmark for investment performance in the energy products of commodity market. Commodity index products available as OTC swap products are generally used for hedging purposes with private parties.

### MCX and iCOMDEX

Moving ahead from its simple COMDEX index that was made available for market participants, on September 26, 2017, Thomson Reuters and MCX launched their co-branded commodity index series called Thomson Reuters-MCX India Commodity Indices (iCOMDEX), tracking the performance of commodities listed on MCX. The series includes a composite index comprising of 11 commodities, sector-based indices (bullion and base metals) and single commodity indices for gold, copper and crude oil. The methodology used to construct these indices follows the International Organisation of Securities Commissions (IOSCO) guidelines for benchmarks. Every incumbent commodity is weighted two-thirds by its liquidity and one-third by its domestic physical market size. Also, each sector has a limit set for its maximum or minimum weighting within the composite basket. The rationale behind having a cap is to prevent any single commodity or sector to exert a disproportionate influence on the index.

The iCOMDEX indices can be used as benchmarks for tracking commodity performance or can be used as an indicator of the market. With the regulatory opening up of commodities derivatives market to institutional investors, they will be able to leverage these indices not only for performance benchmarking, but also to build new products and make efficient investment decisions. Further, when allowed, the exchange can offer derivative products on potential set of indices. Institutional investors like exchange-traded funds (ETFs) can trade in long-term commodity futures contracts with various strategies to replicate or outperform the indices, which will help build liquidity in the far month contracts, serving the cost-effective hedging needs. Commodity index-based products would, therefore, allow different kinds of market participants to trade and invest in commodities on a short- and long-term basis. The same can also be offered to retail investors by institutions.

### That alpha for Indian investors

When combined with other asset classes like equity and debt, commodity products not only offer excellent diversification benefits for asset risk management, but also provide a natural inflation hedge and safe haven against turbulent market times. The advent of commodity ETPs backed by commodity indices can provide investors with access to a wide range of commodity returns. Within the domestic economy, they can provide new investment opportunities with better returns sans currency risk to Indian investors who may otherwise choose to park their investments outside the country to seek superior returns. Unlike the equities and debt market, investors have been typically unfamiliar with the properties of commodities and their relation with other asset classes. Thus, the availability of these products will make it easy for common investors to invest in commodities without getting into the technicalities. A large part of the savings of Indian households can be moved into financial markets through the opening of index-linked commodity products and the alpha it can provide to the already surging DII flows and moderate risks.

### Simpler commodity investing

With the regulatory opening up of commodity markets to institutional investors starting with June 2017, India has seen its first institutional participation from the category III Alternative Investment Funds. Soon, mutual funds and portfolio management services providers may become a part of the commodity derivative ecosystem, institutions which have the capability to offer safe and research-backed, index-tracking products to common investors. Commodity index captures the essence of performance in the commodities without the complication of driving down to fundamentals of each commodity. Introducing commodity indices trading will provide investors new commodity index-based products with significant benefits, including diversification, low costs, competitive performance and, most importantly, the simplicity to participate in commodity markets.

### Primary uses of commodity indices

**BENCHMARK**

- Comparison with other asset classes for performance measure

**INDICATOR**

- Indicator of economic activity, inflationary pressures and the state of global economic production

**INVESTMENT VEHICLE**

- Performance of an index can be replicated by trading the contracts it tracks. Investments can be direct through buying contracts or indirectly like via mutual funds, ETFs etc

### iCOMDEX component weights

