



Managed Commodity Futures

Background

With the setting up of national level multi-commodity exchanges in India, the commodity landscape in the country is changing significantly. These exchanges with their excellent risk management systems and wide reach are attracting a significant number of participants including hedgers, arbitrageurs and speculators.

Investors now have one more distinct asset class viz. commodity futures, which can be included in their investment portfolio. However, most investors lack the expertise to trade in commodity futures, and need to seek professional advice for the same. **Managed Commodity Futures** are a step towards meeting this need of investors.

What are Managed Commodity Futures?

The term Managed Commodity Futures refers to an arrangement wherein professional money managers (known as Commodity Trading Advisors) manage client assets on a discretionary basis using **commodity futures** as the investment medium.

Why should I invest in Managed Commodity Futures?

The benefits of Managed Commodity Futures within a well-balanced portfolio are:

- a) **Portfolio diversification:** Commodity futures are an asset class by themselves, distinct from equity and fixed income. Adding commodity futures to a traditional portfolio of stocks and bonds improves overall diversification and therefore lowers overall portfolio risk.
- b) **Reduction in portfolio volatility:** Returns from commodity futures have been shown to be negatively correlated with returns from equity and fixed income markets, and positively correlated with inflation¹. Hence introduction of commodity futures into a traditional portfolio can smooth out overall returns.
- c) **Potential for absolute returns:** Managed commodity futures can take advantage of price trends no matter which direction the markets move, and thus can generate positive returns even in a volatile economic environment that can cause stress to a typical stock and bond portfolio.
- d) **Participation in global financial markets:** Though the commodity futures markets in India are yet to mature, they are already showing strong linkages with global markets. For example, the prices of bullion and crude futures contracts on the Multi-Commodity Exchange (MCX) are seen to be moving in step with the prices of equivalent contracts on international exchanges like COMEX and NYMEX respectively. Investing in commodity futures is thus seen as a proxy for investing in global financial markets.

¹ Refer Yale ICF Working Paper No. 04-20 (June 2004) "Facts and Fantasies about Commodity Futures" by Gary Gorton and K. Geert Rouwenhorst



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Is investing in commodity futures riskier than investing in equity?

Technically speaking, investing in commodity futures is riskier than investing in equities simply because of the fact that futures are a leveraged product. However, on a level field, commodities are less risky than equities because commodity prices are determined simply by the laws of supply and demand, and factors such as management quality, financial statements veracity etc. do not enter the equation.

Are managed futures accounts viewed as a long-term or short-term trading strategy?

We strongly advise that you do not evaluate the performance of your account on a trade-by-trade or a day-to-day basis. When opening a managed futures account you should be prepared to treat this investment as a longer-term investment even though these accounts do indeed offer a great deal of liquidity.

Is a managed futures account appropriate as a short-term investment?

No. Futures markets, like most markets, tend to be cyclical. Moreover, even an advisor who is highly successful over the course of a year may—and probably will—experience some months in which losses are incurred. Thus, while you are free to close an account at any time (giving at least three months notice), it is probably not a prudent investment strategy to establish an account that you do not plan on maintaining for at least a year.