Commodities – The Alternative Asset Class for Institutional Investing in the 20s

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Why look for an alternative asset class

Any discussion or evaluation on opportunities for Investment, very quickly moves into asset allocation and thereafter underlying products. However, one important step – that many miss out – is retrofitting the goals of investment into the possible asset classes. Typically, the considerations of investing can be classified into three broad buckets: timelines, volatility of returns and liquidity. Timelines can be immediate (less than year), medium term (1-5 years) and finally long term (5 years +). Volatility of returns is typically spread between low to super normal and steady (low probability of losses) to high drawdown assets. Finally, the liquidity – typically exchange traded and fixed payout products versus highly illiquid ones.

The goals versus considerations that finally translate into something like this :

Goal	Returns, Drawdown, Liquidity	Asset classes available
Protection for a rainy day	Perceived stable, Low to High	Bullion, Real Estate, Deposits
Regular income, capital preservation	~10%-12%, ~0%-1%, Medium to High	Arbitrage, Trade Finance, Debt
High returns with limited drawdown	~12%-15%, ~5%-7%, High	Equity, Debt
Long term wealth but high drawdown	~18%-24%, ~>20%, Medium to High	Distressed Credit, Equity
Multi baggers or Complete Bust	~>50%, ~100%, Low to Medium	Startup Equity
Not for necessity but for pleasure	~> 50%, ~100%, Illiquid	Art, Yachts, Diamonds

The recent times have challenged many an assumption on risk and returns. In India, most notably, the perception around debt products has significantly changed – and rightly so. Equities – as expected completely dominates the higher return goals. But what this throws up – interestingly – is that Arbitrage products and Trade Finance are amongst the best bets for regular income with capital preservation and the most obvious asset class for such investments is – Commodities. Commodities is also considered favorably as the rainy-day protection. So – in every sense – the only Alternative that one sees emerging to Equities as an asset class – is Commodities.

In this backdrop, it is important to see how the Commodity and Commodity Derivatives markets in India has developed.

Looking back on Commodities – in India

The history of Commodity Derivatives in India goes back over one and a half century ago to 1875 when Cotton Futures started trading informally. Soon after independence, the Forward Markets Commission (FMC) was established to oversee the trading of commodity futures but within a decade plus India had prohibited the trading of Commodity Futures across the board. The implications are enormous - Two generations have not seen what it means to invest in Commodity Derivatives.

After a gap of almost 40 years, in 2003 the National Commodity Exchanges started trading under the aegis of FMC – even then under the Ministry of Consumer Affairs. That – by construct – ensured that this asset class remained artificially separated from the rest of the financial assets and in many ways ensured that the growth of the market was limited and not inclusive. The launch of Gold ETF and the subsequent absence of a Silver ETF is a great example of what happened due to this dichotomy.

In 2013, the FMC was brought under the Ministry of Finance and as the first half of the financial year 2015-16 was drawing to a close, the Government of India took the logically conclusive step of merging FMC with SEBI. The birth of Commodities – as the alternative asset class – it therefore a very recent phenomenon.

The case for growth in Commodities

As someone who started his career in 1990 and was fortunate enough to still be active in 2015 – this was a rare opportunity – to witness the spectacular growth of the Equities – as an industry and even as a culture in terms of investing habits to now have the opportunity to see something happen in Commodities.

Let us look back at where India's financial services and more specifically equity markets were in the early nineties and where they are now. There are striking similarities of the equity markets of the 90's to the commodity derivatives markets of 2016 and that is what drives this conviction about this new asset class:

1. In the '90s we had a nascent regulator (remember SEBI was formed at the end of the 80's) – and that is the same for commodities under SEBI.
2. Limited products (cash equities only) – just like in commodities (where we had Futures only).
3. Limited institutional participation (mainly Government Institutions such LIC & UTI) but no private sector (domestic or foreign) – in commodities we did not permit Institutions till three years back.
4. Finally, a broken back end (with physical shares). The Depository Act came in '96 only and became a success around a decade later. In commodities, we are just about trying to replicate that under the WDRA through electronic Negotiable Warehouse Receipts (eNWRs) in the Repositories.

Yet – with dogged determination, excellent supervision, and some innovative thinking – starting with SEBI, the Exchanges, Depositories, Mutual Funds, Brokerages, and Issuers – the Indian secondary are today as developed and amongst the safest for investors in the world.

The scorecard

The 5 pillars for the growth of the commodity derivatives markets, namely :

1. Distribution
2. Products
3. Financial participants
4. Physical market hedging
5. Robust infrastructure

Let us assess where we stand on these 5 counts – 5 years into our journey.

Distribution : there were two key drivers – first allowing members of the exchange to hold their commodity derivatives license in the same entity which had the equities license – this was enabled in July 2017 and the second was to persuade RBI to allow bank subsidiaries to become members of commodity derivatives exchanges – which was also done in September 2017.

With both these accomplished, the only gap is in terms of Institutional Broking and Clearing Members – who are yet to join this activity.

Products : Options on Futures, Indices and now Options on Goods – I do not think we could have asked for more products in this short span and it is now up to the market and participants to make it succeed.

Financial Participants : Whilst AIFs were enabled in July 2017 and Mutual Funds two year later, the custodial services were enabled only a few months back. Further, for the non-Institutional participants the current impediments are the lack of liquidity – especially in agricultural contracts and the short-term tenor available – especially since arbitrageurs would typically like to lock in funds for longer term.

Physical market hedging : SEBI made changes to the Listing Obligation and Disclosure Regulations (LODR) making it mandatory for all listed entities to disclose their exposure to and hedging of commodity price risks in late 2015. While this is yet to see any meaningful impact in terms of corporate participation, the ability of the savvier corporates to hedge overseas does diminish the open interest in Indian markets.

Robust infrastructure : The Indian markets, under SEBI, have been amongst the safest when it comes to investor protection. The underdeveloped part – therefore – still remains the warehousing segment – which comes under a different regulator. Unless the use of eNWRs becomes as widespread as that of dematerialized shares – this may well remain the weak link amongst the 5 pillars.

The interesting story about Gold

A lot has been said about the love for Gold for Indian investors. Traditionally, that has been in the physical form but the launch of Gold ETFs (2005) and the more recent Sovereign Gold Bonds have slowly – but surely moved that interest away from the physical. However, this is a limited move – given that both ETFs and SGBs are finally backed by physical gold. It is therefore imperative that India makes the derivative form of Gold – Futures as well as Options – extremely liquid and easy for investors to trade in.

For any derivatives contract to succeed, there are two critical elements – a deep open interest and a very liquid market. The latter – for quite some time – has been maintained through the umpteen trading firms that have used the close linkages of the domestic derivatives price with the international benchmark – as an opportunity to trade. However, for a long time the open interest that is usually built on the back of the physical market has been tepid. This gap was filled through a regulatory fillip in July 2018 that prevented Indian Corporates from hedging their Gold exposure in International exchanges. The open interest in Indian exchanges went through a 5-7 time increase and it seemed that the Indian derivatives had finally made a breakthrough.

But this was a misleading indicator – the entire open interest continues to remain in the near month contract in effect allowing the physical market about 45 days of hedging. What was missing was the long-term interest that could have been on the other side of the domestic corporates (who were generally short) by Institutional flows (who would generally be long – both in tenor and in interest).

As can be seen from the above analysis, there are only two key elements that need further strengthening for the widespread growth of the commodity derivatives market. The first, is the proliferation of eNWRs – but that may require some regulatory intervention. But the second is getting Institutions on board.

In summary,

- There is a clear gap when it comes to identifying the alternative asset class to equities
- Commodities – has all the ingredients needed – to fill that gap in this decade
- The only missing piece is Institutional participation in every possible way

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In an article last year I had said Commodities 1.0 - Done .. Now for 2.0 (https://www.linkedin.com/pulse/commodities-10-done-now-20-mrugank-paranjape/?trackingId=30wFCyz4Iv6WEt%2FUivQB6A%3D%3D) that it is all about execution now.

I will go a bit further and say – it is all about Institutionalisation now.