Growing Interest among Domestic Financial Institutions in Exchange Traded Commodity Derivatives (ETCDs)

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The Indian financial ecosystem is undergoing a transformative shift, marked by an increasing inclination of domestic financial institutions (DFIs) towards the commodity derivatives market. Historically dominated by hedgers, arbitrageurs and individual traders, this space is now attracting the attention of a plethora of institutions, most notably, financial institutions which are already present in the securities market. This growing interest signifies more than a diversification attempt; it reflects an institutional recalibration towards real assets that offer inflation hedging, portfolio risk management and alpha generation.

We explore the rationale behind rising institutional interest in commodity derivatives and the strategic benefits from investment in commodity derivatives.

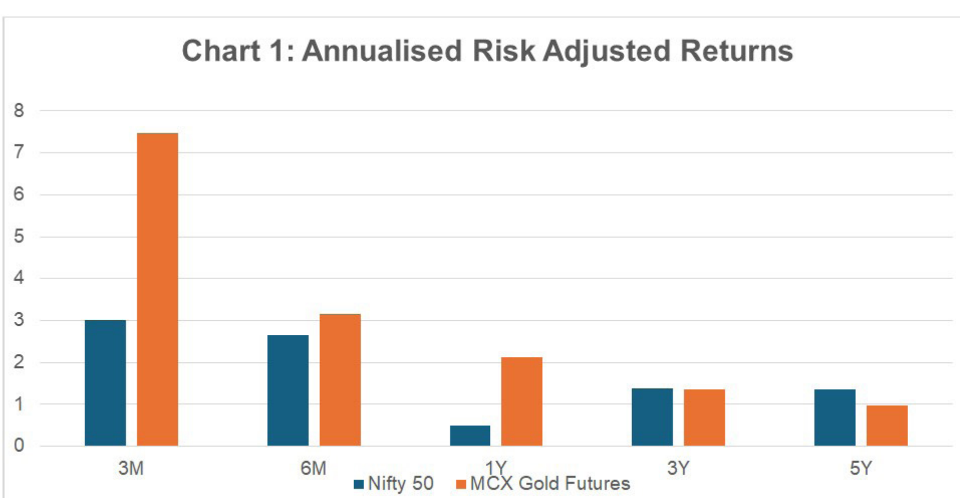
The Institutional Awakening

The Indian commodity derivatives market has been experiencing appreciable growth in recent times, with increasing institutional participation. From traditional players like proprietary trading firms and commodity trading houses, we now see participation and deeper interest from financial institutions such as Mutual Funds, Alternative Investment Funds (AIFs), and Portfolio Management Service (PMS) providers.

The regulatory environment has been instrumental in facilitating this change. The Securities and Exchange Board of India (SEBI) has progressively liberalized participation norms, allowing Category III AIFs (since 2017), Mutual Funds and PMS (both since 2019) to participate in Exchange-Traded Commodity Derivatives (ETCDs), within relevant operational guidelines. These regulatory developments have created a robust framework that ensures transparency, risk management and investor protection while enabling institutions to harness the benefits of commodity exposure.

Strategic Benefits for Mutual Fund Houses

For Mutual Fund houses, commodity derivatives offer compelling strategic advantages that extend beyond traditional equity and debt instruments. The most significant benefit lies in portfolio diversification. Commodities typically exhibit low correlation with traditional asset classes, making them powerful tools for reducing overall portfolio volatility and enhancing risk-adjusted returns (RAR). For instance, over a period up to five years ending 30 June 2025, the RAR of MCX Gold Futures has been comparable or higher than those of NIFTY 50 (Chart 1) in most time periods. RAR indicates the returns that an investment gives relative to the risk taken by the investor. In this case, Sharpe Ratio has been used as a measure of RAR, i.e. the ratio of Annualized Returns to the Annualized Volatility of the two asset classes, assuming risk-free returns as zero. Thus, along with low correlation in returns between commodities and equities, the enhanced RAR of commodities improves the performance of a diversified portfolio that consists of commodities.



Note: Time periods refer to periods ending 30 June 2025.

The inflation hedging characteristic of commodities represents another crucial advantage. In an economy like India's, where energy and materials costs significantly impact inflation dynamics, commodity exposure can serve as a natural hedge against purchasing power erosion. This is particularly relevant for long-term wealth creation strategies, where maintaining real returns becomes paramount. From a global perspective, it has been found that compared to several other asset classes, returns only in Gold display positive correlation with inflation (Chart 2) over a long period of time.

Chart 2: Correlations between Inflation and Asset Returns in Global Markets (1900-2024)

Source: Global Investment Returns Yearbook, UBS, 2025. Figures show correlation of inflation to the average real returns of the respective asset classes using data from 35 countries.

Under regulatory guidelines in India, Mutual Funds can deploy up to 10 percent of their Assets under Management (AUM) in Exchange Traded Commodity Derivatives (ETCDs), unless the scheme falls under a Multi Asset Allocation Scheme in which case the deployment limit for ETCDs is 30 percent. Gold ETFs can deploy up to 50 percent in Gold ETCDs, while Silver ETFs can deploy up to 10 percent in Silver ETCDs. These are significant opportunities for the Mutual Fund industry. Some Multi-Asset Funds, for instance, have introduced schemes incorporating ETCDs, mostly Gold and Silver Futures. The inclusion of commodities enables them to create truly diversified portfolios, which provide their investors with inflation hedging capabilities and portfolio resilience during market volatility.

Further, commodity derivatives enable Mutual Funds to implement tactical asset allocation strategies more effectively. During periods of economic uncertainty or geopolitical tension, commodities often outperform traditional assets, providing portfolio managers with valuable diversification tools.

Operational Advantages and Risk Management

From an operational perspective, commodity derivatives offer Mutual Fund houses several advantages over physical commodity investments. The standardized nature of Exchange-traded commodity derivatives eliminates many of the logistical challenges associated with physical commodity storage, transportation and quality assurance. This efficiency translates into lower operational costs and improved liquidity management for fund managers.

The risk management aspect in portfolio management has also evolved significantly. Modern portfolio management systems can now seamlessly integrate commodity positions into overall risk models, enabling fund managers to maintain precise control over portfolio exposure. Value-at-Risk (VaR) calculations, stress testing and scenario analysis can incorporate commodity positions alongside traditional assets, providing comprehensive risk assessment capabilities.

Simultaneously, the risk management framework in Exchange-traded and centrally-cleared markets has also evolved significantly. Mark-to-market settlement, adequate margining and Exchange guarantee mechanisms provide additional layers of safety that make commodity derivatives attractive for institutional investors. These features ensure transparency and reduce counterparty risk, critical considerations for fiduciary fund managers.

Learning from US Markets

Institutional participation in the US commodity derivatives market has expanded significantly over the years. As of June 2025, out of 4362 ETFs listed in US, 102 were dedicated to commodities, which had a combined Asset Under Management (AUM) of about $222 billion (source: etfdb.com), or ~₹19 lakh crore. The largest commodity ETF had an AUM of about $100 billion (~₹8 lakh crore). These commodity-focused funds concentrate mainly on commodity indices, precious metals, and the energy sector. Some of the largest commodity ETFs, like those focused on gold, illustrate significant investor interest in gaining regulated and accessible exposure to the commodities market through these investment vehicles. While ETFs focusing physical commodities have been prevalent and popular, now even ETFs based out on ETCDs are gaining prominence in the US. Particularly noteworthy is the success of ETCD-based ETFs in the US, with one prominent Futures-based product managing $4.59 billion (~₹40,000 crore) in assets, proving that investors readily accept derivative-based commodity exposure when properly structured.

The differential risks and returns of commodities vis-à-vis other asset classes, underscoring the diversification benefit discussed above, make for a compelling case for institutional funds in the US to include commodities. During the Global Financial Crisis (2008 – 2010), for instance, while a benchmark equity index like S&P 500 declined by 7 percent (Jan ’08 – Dec ’10), Gold rose by 19 percent. Again, during the period of high inflation of 2021-2022, while S&P 500 rose by 2 percent (Jan ’21 – Dec ’22), a diversified commodity index like the Bloomberg Commodity Index posted 20 percent returns in the same period.

This market maturity, reflected in both the diversity of ETF products and the substantial allocation in commodities, showcases how commodities have become a normalized component of diversified investment portfolios for fund houses and their clients in a matured market like the US. The success of this market segment underscores the global recognition of commodities as a distinct asset class offering portfolio diversification, inflation hedging and alternative return streams that complement traditional equity and bond investments.

Growth in India’s commodity derivatives and MFs – can they tango?

India’s Mutual Fund industry has witnessed extraordinary growth in recent times, with AUM reaching about ₹75 trillion by June 30, 2025 – a six-fold increase from an AUM of about ₹12 trillion on June 30, 2015 – in a span of 10 years. A significant driver of this growth has been systematic investment plans (SIPs), with ₹27,269 crore collected through SIPs in June 2025 alone (source: AMFI), demonstrating investor confidence and the disciplined investment approach gaining traction across the country.

At the same time, India’s ETCD market has also been witnessing remarkable growth. Total turnover in the Indian ETCD market touched almost Rs.580 trillion in the year 2024-25, a 107 percent increase from the previous year, which itself had witnessed a 97 percent increase from the year 2022-23. The ETCD market is also characterised by a diverse product suite, flexibility in contracts size and trade timings till almost midnight. Participants have a variety of trading instruments to choose from – from Futures on commodities to Options on such Futures and derivative instruments on commodity indices. The largest Commodity Exchange, MCX, has 552 members with trading rights and its clearing house, MCXCCL, has 220 Members with clearing rights, some of who, such as commercial banks, fall in the category of ‘Professional Clearing Members’. Further, the risk management and settlement systems of MCXCCL are state-of-the-art, as discussed above, supported by a Settlement Guarantee Fund (exceeding ₹ 965 crore as in the beginning of July 2025), which provides market participants with a high level of comfort and confidence in the integrity of the ETCD market.

It is, therefore, apposite for these two large and growing industries in India’s financial market – Mutual Funds and ETCDs - to develop a symbiotic relationship, which further serves their respective clientele and deepens their respective markets.

Looking ahead …

The growing interest among domestic financial institutions for commodity derivatives represents a journey towards maturity in the Indian financial markets. For Mutual Funds and Alternative Investment Funds, this journey offers a less-explored opportunity to enhance portfolio construction, provide better investor returns and differentiate their investment offerings in an increasingly competitive landscape. Yet, there is quite a distance to be covered before the landscape starts to resemble anything close to matured markets. For instance, as against 102 ETFs dedicated to commodities in the US, the corresponding number in India is much smaller.

Nevertheless, as we look forward, the potential for further growth in participation by domestic financial institutions in commodity derivatives remain substantial. The US experience suggests that we are still in the early stages of this transformation, with significant room for expansion as more institutions recognize the strategic value of commodity exposure.

The time is opportune for Mutual Fund houses, Alternative Investment Funds and the newly created Specialised Investment Funds to seriously consider expanding their portfolios to include ETCDs. Those which embrace this opportunity early will be best positioned to capture the benefits of this growing asset class and provide superior outcomes for their investors. Market Infrastructure Institutions in India’s ETCD market stand ready to support this growth, offering the infrastructure, instruments and expertise necessary for successful institutional participation.