Certified Commodity Trader Sample Material

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1. INTRODUCTION

A 'commodity' can be termed as a product with a value of commercial utility. It is a tangible entity that can be bought and sold. A transaction between buyers and sellers taking place for the disposal or acquirement of commodities is called commodity trading.

On a global basis, commodities markets are massive and trade in trillions of dollars on a daily basis. There is also much diversity. For example, investors can invest in the following categories

- ✓ Agriculture: Includes corn, wheat, soybeans, cotton, sugar, cocoa, orange juice, coffee, and oats.
- ✓ Livestock: Includes live cattle, feeder cattle.
- ✓ Precious metals: Includes gold, silver, and platinum.
- ✓ Industrial metals: Includes copper, palladium, aluminum, tin, nickel, zinc, lead, and cobalt.
- ✓ Energy: Includes crude oil, unleaded gasoline, natural gas, coal, heating oil, uranium, ethanol, and electric power.

In India, the market for commodities starts at 1000 hours to 2300/2355 hours. Two major commodity exchanges in India are the MCX & NCDEX. Going further, we will take a closer look at these exchanges along with an insight on the global commodity markets, the instrument's history and its various utilities.

1.1 Commodity Exchanges in India

A 'commodity exchange' is corporate body or an association that organises trading in commodities by granting licenses under the regulating authority. There are about 25 recognized future exchanges in India. Out of these, there are four national level multi-commodity exchanges.

The Government of India now allows forward transactions in commodities through Online Commodity Exchanges to help in better risk coverage and management as well as the delivery of commodities. This is an added feature to the traditional mode of business called 'Adhat' and 'Vayda Vyapar'.

1.2 Global Commodity Markets

Globally, there are futures trading exchanges in over twenty countries that include France, Singapore, Japan, Canada, England, India, Australia and New Zealand. The largest commodity exchange in USA is Chicago Board of Trade, The Chicago Mercantile Exchange, the New York Commodity Exchange, the New York Mercantile Exchange, and New York Coffee, and Sugar and Cocoa Exchange.

The main commodity exchanges in the world cover:

- ✓ New York Mercantile Exchange (NYMEX)
- ✓ London Metal Exchange (LME)
- ✓ Chicago Board of Trade (CBOT)
- ✓ New York Board of Trade (NYBOT)
- ✓ Kansas Board of Trade
- ✓ Winnipeg Commodity Exchange, Manitoba
- ✓ Dalian Commodity Exchange, China
- ✓ Bursa Malaysia Derivatives exchange
- ✓ Singapore Commodity Exchange (SICOM)
- ✓ Chicago Mercantile Exchange (CME), US
- ✓ London Metal Exchange
- ✓ Tokyo Commodity Exchange (TOCOM)
- ✓ Shanghai Futures Exchange
- ✓ Sydney Futures Exchange
- ✓ London International Financial Futures and Options Exchange (LIFFE)
- ✓ Dubai Gold & Commodity Exchange (DGCX)
- ✓ Dubai Mercantile Exchange (DME)

Commodity exchanges over the world have evolved over time. Most of the exchanges we have today were incorporated during the late 19th and early 20th century. The first of these exchanges was in Chicago (US) called the Chicago Board of Trade (CBOT). In order to curb risk, the derivatives instruments came into effective practice during the 1970-80's. This helped the expansion the commodity exchange and trading.

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Through the ages, the evolution of the exchanges has been fuelled by the needs of businessmen and farmers. The objective was to gather buyers and sellers at a centralised location to ease the process of buying and selling commodities.

The exchange started our well in the US during the 1800s. Soon, however, there was a surplus of commodities at harvest time in some years and severe shortages during years of crop failure. The difficulties in transportation and the lack of proper storage facilities further aggravated the problem of demand and supply imbalance. The uncertain market conditions led farmers and merchants to enter contracts for forward delivery.

Corn was one of the first contracts to be traded on in 1851. The popularity and expansion of this commodity lead to approximately 82 merchants to form the Chicago Board of Trade (CBOT). The forward contracts did very well in the initial years but due to certain drawbacks such as dearth of standardization and non-fulfillment of commitments, the Board took initiatives to formalize trading in 1865.

Once formalization to place, the futures market began efficient methods of managing counter-party and price risks. The clearing house became the responsible for the performance of contracts and margin collections. As more trading started taking place, the trading practices also got refined leading to clear and established rules and regulations for the clearing and settlement houses.

In the early 1900s, new types of exchanges began appearing that were not based on agricultural products. These were instruments derived from financial products. Its significance grew at this time as the Bretton Woods System of fixed exchange rates had just ended in the 1970s. To hedge against risk, currency derivatives were introduced followed by other types of derivatives such as stock index futures.

Apart from the United States, one of the oldest exchanges is found in Argentina. Setup in 1854, The Buenos Aires Grain Exchange saw the early use of commodity risk-management instruments. This increased government intervention and policies impeded the development of futures markets. The government was unsuccessful in stabilizing the prices. After the 1980s, the country adopted liberalisation and globalisation policies that have help the revival of the commodity market in these countries.

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1.3 Commodity Markets in BRIC Nations

The main players in emerging markets—Brazil, Russia, India, and China—combined have 42% of the world's population and are responsible for approx 23% of the world's output.

Brazil

Brazil is a country that has had its share of turmoil. Until the mid-1980s, the government had military dictatorships and populist leaders. The country also experienced severe bouts of inflation and economic slumps. But over the past decade, Brazil has made great strides.

The country has rich natural resources and a large workforce. Because of its tropical climate, it is possible to grow crops year-round in Brazil. Some of the key crops include coffee and sugarcane.

Oil is another big commodity. Over the years, there have been major discoveries off its shores. Brazil also has the second-largest mining company in the world, which is Vale. It produces nickel, coal, aluminum, and other commodities. The gross domestic product (GDP) of Brazil is roughly $2.2 trillion and the economy grew by about 7.5 percent in 2010. Because of the strength of its economy, the country has been a popular destination for foreign investment.

Russia

Since communism was abolished in the early 1990s, Russia has undergone extreme changes. During 1998, the country defaulted on its foreign debt. The result was an economic plunge. Despite all this, Russia remains a major power. Besides being a big producer of oil and natural gas, the country also has large deposits of iron ore, bauxite, and gold. The GDP is $2.2 trillion and the economy grew by 3.8 percent in 2010. However, there are still big challenges. Corruption is a big problem in Russia. Moreover, Russia has had difficulty in attracting foreign capital because of the uncertainty regarding property rights.

India

Because it was originally under British rule, India has a Western legal system and other institutions. This certainly makes international trade easier. But since gaining independence in 1947, India has seen lots of problems. The Gandhi and Nehru governments focused on a pro-socialist agenda, which had a dampening impact on the economy. Yet since the early 1990s, there has been a move toward free-market economics. As a result, growth has been particularly strong and India has become a leader in industries like information technology. With a population of 1.2 billion, India has a GDP of about $4 trillion. In 2010, the economy grew by about 8.3 percent.

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China

When it comes to investing in commodities, perhaps the most important driving factor is China. The country has shown an insatiable appetite for many commodities and the demand is likely to continue for many years. The country has had the largest economy for 18 of the past 20 centuries. China has a long history of innovation and international trade. But during the twentieth century, there was mostly turmoil. During the first half of the century, Japan invaded China several times. In 1949, Mao Zedong came to power and created a communist state, called the People's Republic of China. There were purges, famines, and massive takeovers of private businesses. The upshot was a substantial decline in the national economy.

But in the late 1970s, there was a major shift. Deng Xiaoping, who was a key player in the communist revolution, began the process of economic reforms. Interestingly enough, he said that "being rich is glorious." The reforms certainly paid off. Over the past 26 years, China has had the fastest growing economy in the world, with its GDP increasing by roughly ten times. The economy is now ranked second in the world and is expected to surpass the economy of the United States by 2027. Even with the global financial crisis of 2008, China was able to recover quickly. Consider that within two years, the economy was already 20 percent higher.

1.4 History of Commodity Derivatives in India

Commodity futures markets have a long history in India. Cotton was the first commodity to attract futures trading in the country leading to the setting up of the Bombay Cotton Trade Association Ltd. in 1875. After this, derivatives trading started in

- ✓ oilseeds in Bombay (1900)
- ✓ raw jute and jute goods in Calcutta (1912)
- ✓ wheat in Hapur (1913)
- ✓ bullion in Bombay (1920)

Many feared that derivatives would lead to unnecessary speculation in essential commodities, and were harmful to the healthy functioning of the markets for the underlying commodities, and also to the farmers. The Bombay government prohibited options business in 1939 to restrict speculative activity in cotton market. Soon after in 1943, forward trading was prohibited in oilseeds and some other commodities including food-grains, spices, vegetable oils, sugar and cloth.

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1893

The Bombay Cotton Exchange Ltd. was established following the widespread discontent amongst leading cotton mill owners and merchants over the functioning of Bombay Cotton Trade Association. Subsequently, many exchanges came up in different parts of the country for futures trading in various commodities.

1900

Futures trading in oilseeds started with the establishment of the Gujarati Vyapari Mandali, which carried on futures trade in groundnut, castor seed and cotton.

1913

Chamber of Commerce at Hapur began futures trading in wheat and served as the price setter in that commodity till the outbreak of the Second World War.

1919

Calcutta Hessian Exchange Ltd. was established for futures trading in raw jute and jute goods.

1920

Futures trading in bullion began in Mumbai and subsequently markets came up in other centres like Rajkot, Jaipur, Jamnagar, Kanpur, Delhi and Kolkata.

1927

Calcutta Hessian Exchange organized futures trading in raw jute began with the establishment of East Indian Jute Association Ltd.

1939

Before the Second World War broke, several futures markets in oilseeds were functioning in Gujarat and Punjab. Futures trading in wheat existed at several places in Punjab and Uttar Pradesh including Chamber of Commerce at Hapur served as the price setter in that commodity till the outbreak of the Second World War in 1939.

1945

Calcutta Hessian Exchange and East India Jute Association amalgamated to form the

East India Jute & Hessian Ltd. to conduct organized trading in both raw jute and jute goods. Several other exchanges were also created in the country to trade in such diverse commodities as pepper, turmeric, potato, sugar and gur (jaggery).

Post 1947

With the subject of `Stock Exchanges and futures markets' being brought under the Union list, responsibility for regulation of commodity futures markets devolved on the Government of India.

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1952

A Bill on forward contracts was referred to an expert committee headed by Prof. A. D. Shroff and select committees of two successive Parliaments and Forward Contracts (Regulation) Act, 1952, was enacted. The Forward Contracts (Regulation) Act, 1952 had a 3-tier regulatory system - An association recognized by the Government of India on the recommendation of Forward Markets Commission, The Forward Markets Commission (it was set up in September 1953) and The Central Government.

1954

Forward Contracts (Regulation) Rules were notified by the Central Government.

1960

The government banned futures trading in commodities as this was a period which was associated with wars, natural calamities and disasters which invariably led to shortages and price distortions. Production levels were low and had not stabilized; there was the constant fear of misuse of these platforms which could be manipulated to fix prices by creating artificial scarcities.

1980

The Khusro Committee which was constituted recommended reintroduction of futures trading in most of the major commodities. The government, accordingly initiated futures trading in Potato during the latter half of 1980 in quite a few markets such as Punjab and Uttar Pradesh.

1991

Government constituted another committee on Forward Markets under the chairmanship of Prof. K.N. Kabra. The Committee which submitted its report in September 1994 recommended that futures trading be introduced in the other important commodities such as Basmati Rice, Cotton, Kapas, Raw Jute etc. and other goods like pepper and castor seed be upgraded to the level of international futures markets.

1996

UNCTAD and World Bank joint Mission Report "India: Managing Price Risk in India's Liberalized Agriculture: Can Futures Market Help? (1996)" highlighted the role of futures markets as market based instruments for managing risks and suggested the strengthening of institutional capacity of the Regulator and the exchanges for efficient performance of these markets.

2000

The National Agricultural Policy expressed support for commodity futures. The Expert Committee on Strengthening and Developing Agricultural Marketing emphasized the need for and role of futures trading in price risk management and in marketing of agricultural produce.

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2002

The liberalized policy being followed by the Government of India and the gradual withdrawal of the procurement and distribution channel necessitated setting in place a market mechanism to perform the economic functions of price discovery and risk management. The Hon'ble Finance Minister in the Budget Speech for 2002-2003 were indicative of the Governments resolve to put in place a mechanism of futures trade/market.

2003

Government issued notifications permitting futures trading in the commodities, with the issue of these notifications futures trading is not prohibited in any commodity. Options' trading in commodity is currently barred. The year also witnessed the establishment of three new national exchanges: NCDEX, MCX, and NMCE with on-line trading and professional management. The new exchanges brought capital, technology and innovation to the market.

2007

Due to mistaken apprehensions that futures trading contributes to inflation, futures trading quite a few commodities were banned or suspended. Two pulses- Tur and Urad.; two from cereals group- Wheat (till 2009) and Rice; and soon after suspension of futures trading in Chana, Soya oil, Rubber and Potato till late 2008.

2009

Suspension in trading for futures in sugar

1.4 Policy Initiatives

In 1952 the Parliament passed Forward Contracts (Regulation) Act that regulated forward contracts in commodities all over India. The Act applies to any movable property (goods) other than security, currency and actionable claims. It prohibited goods to be traded in Options.

The Act envisages (imagine) three-tier regulation,

- ✓ The Exchange which organizes forward trading in commodities can regulate trading on a day-to-day basis,
- ✓ The Forward Markets Commission provides regulatory oversight under the powers delegated to it by the central Government,
- ✓ The Central Government - Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution - is the ultimate regulatory authority.

Through 1970-80, the Government relaxed forward trading rules for some commodities.

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In 1993, after the economic reforms in 1991, Prof. K.N Kabra was appointed the chairman of the Forward Markets by the government of India. The Kabra committee was set up with the following objectives.

- ✓ To assess the working of the commodity exchanges and their trading practices in India
- ✓ To make suitable recommendations with a view to making them compatible with those of other countries
- ✓ To review the role that forward trading has played in the Indian commodity markets during the last 10 years.
- ✓ To examine the extent to which forward trading has special role to play in promoting exports.
- ✓ To suggest measures to ensure that forward trading in the commodities in which it is allowed to be operative remains constructive and helps in maintaining prices within reasonable limits.

The report for this committee "The Kabra Committee Report" was submitted in September 1994 with the following recommendations,

- ✓ The Forward Markets Commission (FMC) and the Forward Contracts (Regulation) Act, 1952, would need to be strengthened.
- ✓ Ensuring capital adequacy norms and encouraging computerisation would eliminate the difficulties faced with the current inadequate infrastructural facilities such as space and telecommunication facilities. The commodities exchanges would function efficiently.
- ✓ In-built devices in commodity exchanges such as the vigilance committee and the panels of surveyors and arbitrators are strengthened further.
- ✓ The Indian regulatory body for forwards and futures – FMC should continue to monitor the activities and operations of the commodity exchanges. The FMC should be the only authority to approve amendments to the rules and regulations and bye-laws of the commodity exchanges.

Forward Contracts (Regulation) Act 1952, permits option trading in goods and registration of brokers with Forward Markets Commission. Trading was permitted in all commodities recommended by the commission. As the utility of the global commodity market increased in the decades to follow, the Act was placed quite time to serve and advantage to India as well.

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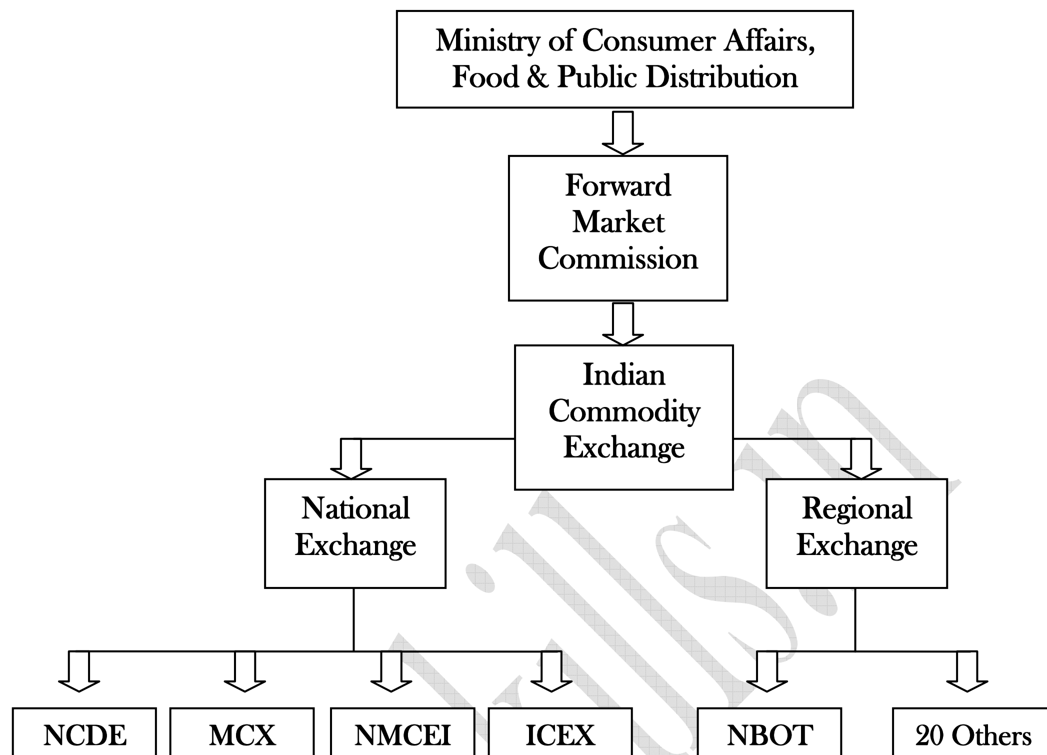
1.5 Structure of the Indian Commodity Market



Ministry of Consumer Affairs, Food and Public Distribution

The Department pertaining to consumer affairs is responsible for the formulation of policies for:

- Monitoring Prices
- Consumer Movement in the country
- Controlling of statutory bodies (Bureau of Indian Standards (BIS) and Weights and Measures)
- Internal Trade
- Inter-State Trade- The Spirituous Preparations (Inter-State Trade and Commerce) Control Act, 1955 (39 of 1955).
- Control of Futures Trading- the Forward Contracts (Regulations) Act, 1952 (74 of 1952)

The Department for food and public distribution is responsible for the formulation of policies for:

- Ensuring food security for the country through timely and efficient procurement and distribution of food grains.
- Building up and maintenance of food stocks, their storage, movement and delivery to the distributing agencies and monitoring of production, stock and price levels of food grains.

- Incentivizing farmers through fair value of their produce by way of Minimum Support Price mechanism, distribution of food grains to Below Poverty Line (BPL) families.
- Covering poor households at the risk of hunger under Antyodaya Anna Yojna (AAY).
- Establishing grain banks in food scarce areas and involvement of Panchayati Raj Institutions in Public Distribution System (PDS).
- Concerns for the sugar sector such as fixing of Fair and Remunerative Price (FRP) of sugarcane payable by Sugar factories, development and regulation of sugar industry (including training in sugar technology), fixation of levy price of sugar and its supply for PDS and regulation of supply of free sale sugar.
- Export and import of food grains, sugar and edible oils.

Forward Market Commission

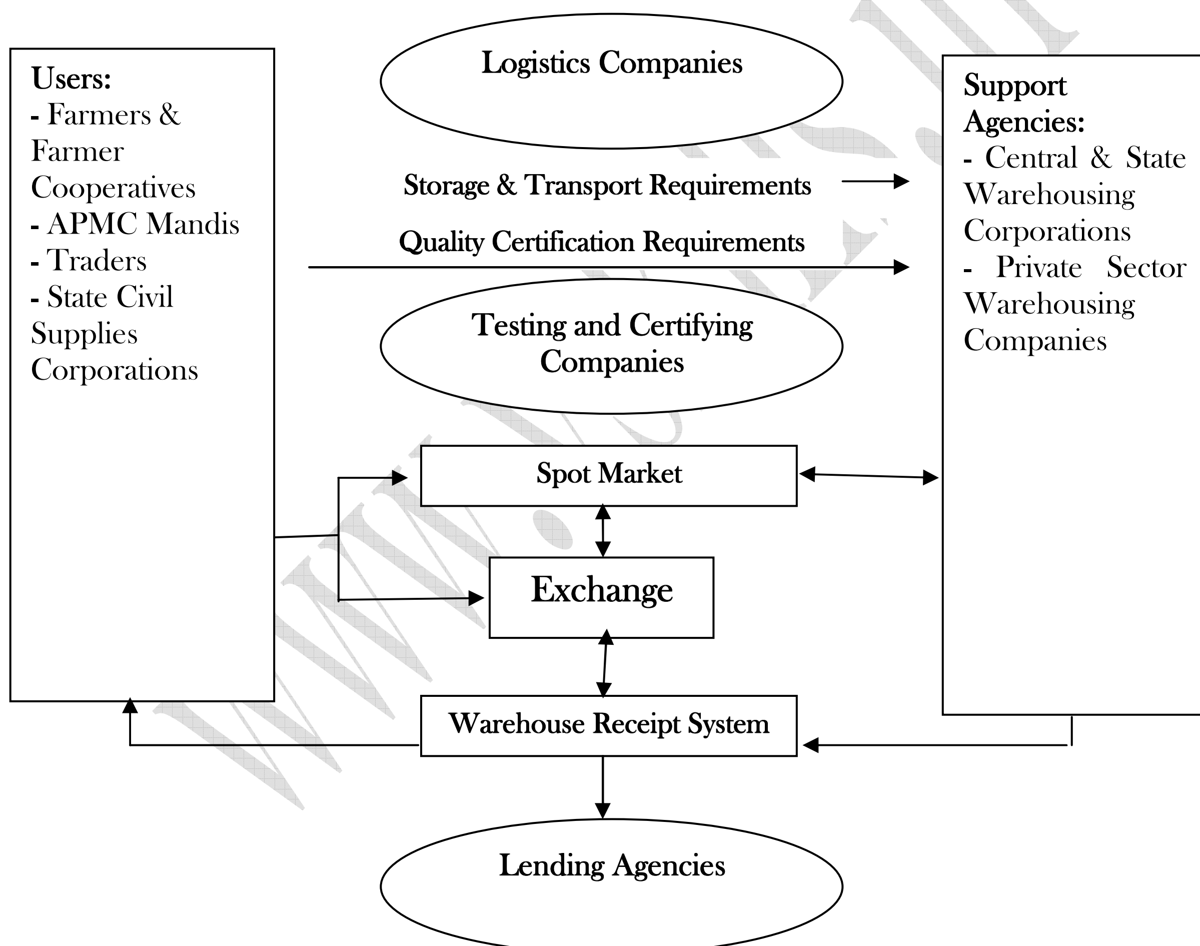
The Commission functions under the control of the Ministry of Consumer Affairs, Food & Public Distribution, Department of Consumer Affairs, Government of India. The functions of the Forward Markets Commission are:

- To advise the Central Government in respect of the recognition or the withdrawal of recognition from any association or in respect of any other matter arising out of the administration of the Forward Contracts (Regulation) Act 1952.
- To keep forward markets under observation and to take such action in relation to them, as it may consider necessary, in exercise of the powers assigned to it by or under the Act.
- To collect and whenever the Commission thinks it necessary, to publish information regarding the trading conditions in respect of goods to which any of the provisions of the Act is made applicable, including information regarding supply, demand and prices, and to submit to the Central Government, periodical reports on the working of forward markets relating to such goods.
- To make recommendations generally with a view to improving the organization and working of forward markets.
- To undertake the inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considers it necessary.

1.6 Parties of a Commodity Exchange & Trading

There are three different types of players in the commodity markets

- ✓ Commercials: The entities involved in the production, processing or merchandising of a commodity. For example, both the corn farmer and Kellogg's from the example above are commercials. Commercials account for most of the trading in commodity markets.
- ✓ Large Speculators: A group of investors that pool their money together to reduce risk and increase gain. Like mutual funds in the stock market, large speculators have money managers that make investment decisions for the investors as a whole.
- ✓ Small Speculators: Individual commodity traders who trade on their own accounts or through a commodity broker. Both small and large speculators are known for their ability to shake up the commodities market.



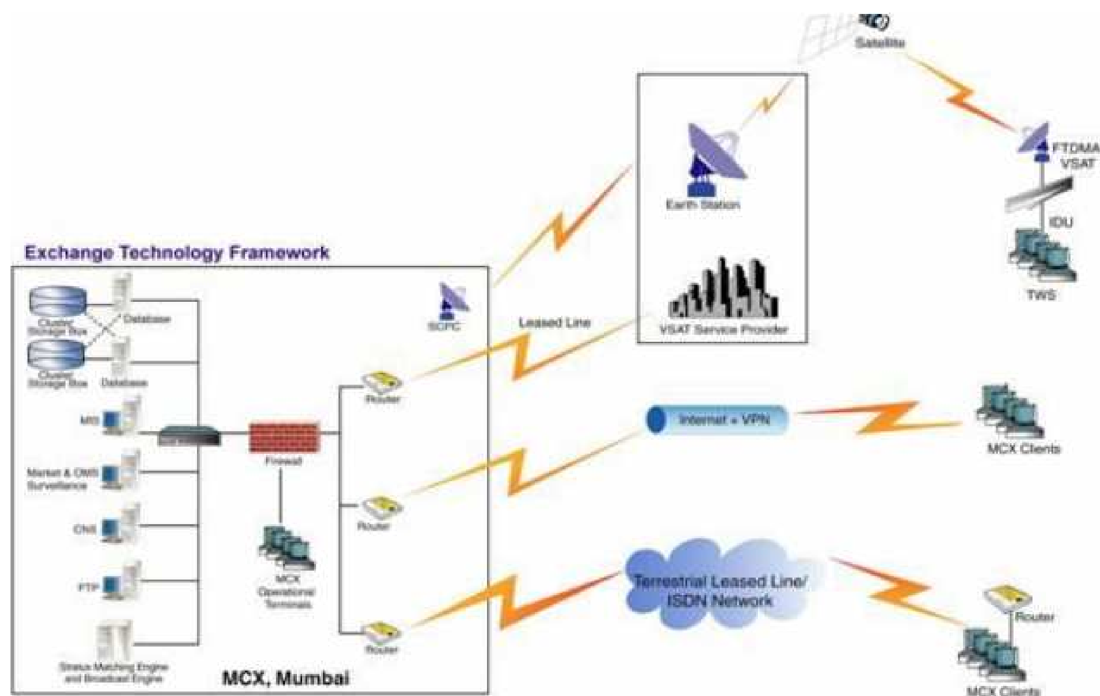
1.7 Latest Development

The commodity market in India has been showing resilience with a steady growth rate. The development of new the Electronic Spot Exchanges provide real time, online, transparent and vibrant spot platform for commodities. The contracts allow participants from various locations

across the country to execute buy and sell orders, thereby enabling producers and users to discover best price.

Because of the growth and expansion of the commodity exchange since 2009, the Government has permitted the National Commodity Exchanges to set up three spot exchanges

- ✓ The National Spot Exchange Ltd. (NSEL),
- ✓ NCDEX Spot Exchange Ltd.,
- ✓ NSPOT and National Agriculture Produce Marketing Company of India Ltd. (NAPMC).



In order to overcome current inefficiencies in the commodities spot market and to bring transparency in trading in commodity spot markets, NCDEX has set up an electronic spot exchange called NCDEX Spot Exchange Limited.

The spot exchanges will cover the entire spectrum of commodities across the country and will bring home the advantages of an electronic spot trading platform to all market participants. These spot exchanges will allow,

- ✓ A direct market linkage among farmers, processors, exporters and end users
- ✓ A view to reducing the cost of intermediation and enhancing price realization by farmers
- ✓ They will also provide the most efficient spot price inputs to the futures exchanges.

- ✓ The exchanges would make possible for farmers to trade easily on the platform by providing real-time access to price information and a simplified delivery process, thereby ensuring the best possible price.

The growth paradigm of India's commodity markets is best reflected by the figures from the regulator's official website, which indicated that the total value of trade on the commodity futures market in the financial year 2008/09 was INR52.49 lakh crore (over US$1 trillion) as against INR 40.66 lakh crore in the preceding year, registering a growth of 29.09%, even under challenging economic conditions globally. The main drivers of this impressive growth in commodity futures were the national commodity exchanges.

MCX, NCDEX and NMCE along with two regional exchanges – NBOT Indore and ACE, Ahmedabad – contributed to 99.61% of the total value of commodities traded during 2008/09. More than 100 commodities are today available for trading in the commodity futures market and more than 50 of them are actively traded. These include bullion, metals, agricultural commodities and energy products. Most importantly, an archaic market has suddenly turned into an organized, service-oriented set-up with shooting volumes.

The unqualified success of the futures market has ensured the next step, i.e., the launch of electronic spot markets for agro-products. Being in a time-zone that falls in the gap left by the major commodity exchanges in the US, Europe and Japan has also worked in India's favor because commodity business by its very nature is a 24/7 business.

Innovation coupled with modern and successful financial market environment has ensured the beginning of a success story in commodities which will eventually see India becoming a price-setter in major commodities on the strength of its large production and consumption.

Future Prospects

With the gradual withdrawal of the Govt. from various sectors in the post liberalization era, the need has been left that various operators in the commodities market be provided with a mechanism to hedge and transfer their risk. India's obligation under WTO to open agriculture sector to world trade require future trade in a wide variety of primary commodities and their product to enable divers market functionaries to cope with the price volatility prevailing n the world markets.

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Following are some of applications, which can utilize the power of the commodity market and create a win-win situation for all the involved parties:

- ✓ Regulatory approval/permission to FIIs to trading in the commodity market
- ✓ Active Involvement of mutual fund industry of India
- ✓ Permission to Banks for acting as Aggregators and traders
- ✓ Active involvement of small Regional stock exchanges
- ✓ Newer Avenues for trading in Foreign Derivatives Exchanges
- ✓ Convergence of variance market
- ✓ Amendment of the commodities Act and Implementers of VAT
- ✓ Introduction of option contract

1.8 Benefits of Commodity Markets

The main objective of any futures exchange is authentic price discovery along with proficient price risk management. It is because of these features of the futures exchanges that a lot of businesses and services are capable of performing efficiently.

- ✓ **Price Discovery:** Futures trading conducted at exchanges is largely based on features such as market information, expert views and comments, the demand/supply equilibrium, weather forecasts, inflation rates, interest rates, Government policies, policy changes, market dynamics, hopes and fears, and buyers' and sellers' sentiment. This results in a continuous price discovery mechanism. The trades executed among buyers and sellers leads to the valuation of the fair value of a particular commodity. This is immediately circulated on the trading terminals.
- ✓ **Predictable Pricing:** Manufacturers and producers must ensure stability in the prices of the goods as the demand for it is highly elastic and they need to protect their market share with the free entry of imports. Futures contracts will allow the manufactures to be able to predict domestic prices and smooth out the effect of changes in their input prices. This futures market prevents manufacturers from being subject to severe short-term price movements of oils and the necessity to maintain price stability.
- ✓ **Price Risk Management:** Hedging is a strategy by which a trader takes an equal but opposite position in the futures market to curb the risk of a loss. Futures markets are used as a mode by hedgers to protect their business or trades from adverse price changes that could hamper the profitability of a business.

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- ✓ **Import- Export competitiveness:** The exporters can hedge their price risk and improve their competitiveness by making use of futures market. A majority of traders which are involved in international trade buy forwards. The purchases made from the physical market might expose them to the risk of price risk resulting in losses. The existence of futures market allows the exporters to hedge their proposed purchase by temporarily substituting for actual purchase till the time is ripe to buy in physical market. In the absence of futures market it will be meticulous, time consuming and costly physical transactions.
- ✓ **Improved product quality:** The existence of warehouses for facilitating delivery with grading facilities along with other related benefits provides a very strong reason to upgrade and enhance the quality of the commodity to grade that is acceptable by the exchange. It ensures uniform standardization of commodity trade, including the terms of quality standard: the quality certificates that are issued by the exchange-certified warehouses have the potential to become the norm for physical trade.
- ✓ **Benefits for farmers/Agriculturalists:** Price instability has a direct bearing on farmers in the absence of futures market. There would be no need to have large reserves to cover against unfavorable price fluctuations. This would reduce the risk premiums associated with the marketing or processing margins enabling more returns on produce. Storing more and being more active in the markets. The price information accessible to the farmers determines the extent to which traders/processors increase price to them. Since one of the objectives of futures exchange is to make available these prices as far as possible, it is very likely to benefit the farmers. Also, due to the time lag between planning and production, the market-determined price information disseminated by futures exchanges would be crucial for their production decisions.
- ✓ **Credit accessibility:** The absence of proper risk management tools would attract the marketing and processing of commodities to high-risk exposure making it risky business activity to fund. Even a small movement in prices can eat up a huge proportion of capital owned by traders, at times making it virtually impossible to payback the loan. There is a high degree of reluctance among banks to fund commodity traders, especially those who do not manage price risks. If in case they do, the interest rate is likely to be high and terms and conditions very stringent. This possesses a huge obstacle in the smooth functioning and competition of commodities market. Hedging, which is possible through futures markets, would cut down the discount rate in commodity lending.
- ✓ **Transparency:** Commodity derivatives markets are extremely transparent in the sense that the manipulation of prices of a commodity is extremely difficult due to globalization of

economies, thereby providing for prices benchmarked across different countries and continents. For example, gold, silver, crude oil, natural gas, etc. are international commodities, whose prices in India are indicative of the global situation.

- ✓ Diversification: Commodities have historically an inverse correlation of daily returns as compared to equities. The skewness of daily returns favors commodities, thereby indicating that in a given time period commodities have a greater probability of providing positive returns as compared to equities. Another aspect to be noted is that the "sharpe ratio" of a portfolio consisting of different asset classes is higher in the case of a portfolio consisting of commodities as well as equities. Thus, an investor can effectively minimize the portfolio risk arising due to price fluctuations in other asset classes by including commodities in the portfolio.
- ✓ **Useful to the producer:** Commodity trade is useful to the producer because he can get an idea of the price likely to prevail on a future date and therefore can decide between various competing commodities, the best that suits him.
- ✓ **Option for high net worth investors:** With the rapid spread of derivatives trading in commodities, the commodities route too has become an option for high net worth and savvy investors to consider in their overall asset allocation.
- ✓ **Useful for the consumer:** Commodity trade is useful for the consumer because he gets an idea of the price at which the commodity would be available at a future point of time. He can do proper costing/financial planning and also cover his purchases by making forward contracts. Predictable pricing and transparency is an added advantage.

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