The Introduction of Commodity Funds and its impact on Mutual Funds Industry

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Investors often look to commodities as a way to potentially achieve enhanced portfolio diversification, protection against inflation, and equity-like returns. As such, commodities have gained attention among institutional and retail investors in recent years, either as a separate asset class or as part of a real assets allocation. Generally, commodities have low or negative correlation with traditional asset classes over the long-term, and can act as a portfolio diversifier. During inflationary times, many investors look to asset classes like commodities to protect the purchasing power of their capital. By adding this asset classes to their portfolios, investors seek to provide multiple degrees of downside protection and upside potential. In Pakistan, after forming of the Pakistan Mercantile Exchange Limited (PMEX) both institutional and individual investors have shown greater interest in taking exposure into commodities. Subsequently development of the commodity exchange has also provided a platform for the mutual fund industry of Pakistan to explore development of commodity based investment schemes. Asset mangers have thus tried to seize this opportunity by introducing commodity mutual funds given the increasing appetite for the asset class.

ROLE OF COMMODITIES IN THE PORTFOLIO

Having commodities in a portfolio have two distinct advantages.

Commodity as a risk diversifier

Studies have shown that adding commodities in the portfolio of stocks and bonds have risk diversifying affects. In order to validate this argument a study was conducted by Center for International Securities and Derivatives Markets (CISDM) where portfolios have been constructed from Goldman Sachs Commodity Index (GSCI), S&P 500, Lehman Gov./Corp. Bonds, MSCI World and Lehman Global Bond indices. The constituents of the portfolios are given in the notes following the table 1. The table below demonstrates the returns for the period 1990-2004 for four different portfolios. Portfolio I and III are portfolios that have no exposure to the commodities whereas portfolios II and IV have exposure to commodity index. As can be seen from the table correlation of Goldman Sachs Commodity Index (GSCI) to portfolio I and III has correlation close to zero that means the returns of commodities have almost no relationship with equity and bond market returns. Thus in the face of negative equity or bond market returns, commodities are less likely to give a negative return. Furthermore, portfolios II and IV have commodity exposures of 20% and have a higher Sharpe ratio than portfolio I and III thus an improvement in risk-adjusted return (a higher Sharpe ratio). Therefore, it is safe to assume that commodities do help diversify risk in a portfolio.

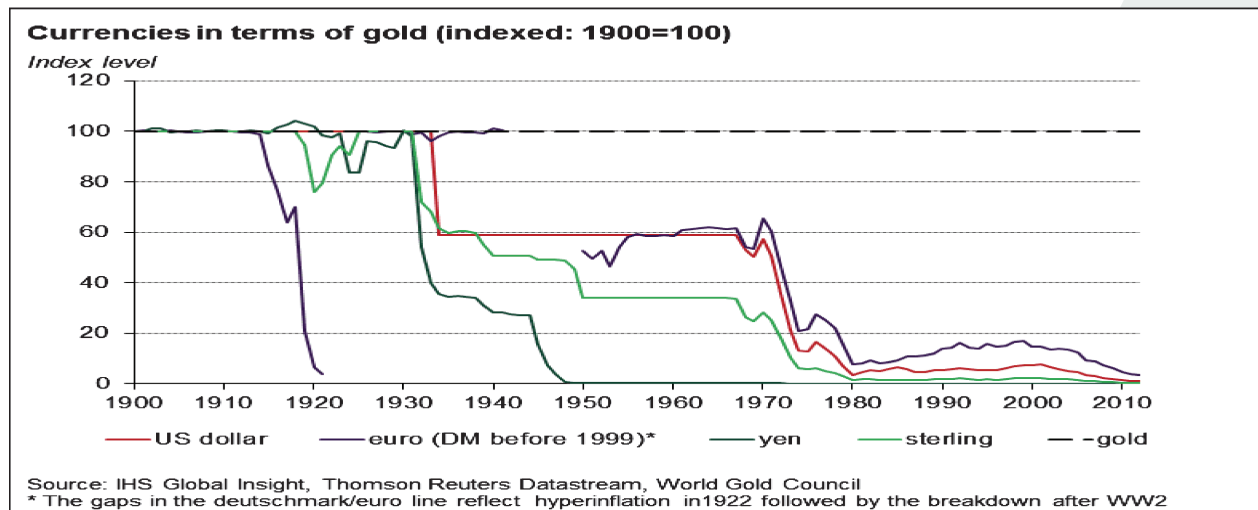
Commodities performance in portfolios 1990-2004				
Measure	**Portfolio I**	**Portfolio II**	**Portfolio III**	**Portfolio IV**
Annualized return	9.64%	9.51%	7.86%	8.07%
Annualized standard deviation	7.94%	7.19%	8.29%	7.55%
Sharpe ratio	0.67	0.73	0.43	0.5
Correlation with GSCI	-0.07	0.47	-0.03	0.48

Notes:
Portfolio I: 50% S&P 500,
50% Lehman Gov./Corp. Bonds.
Portfolio II: 40% S&P 500,
40% Lehman Gov./Corp. Bonds, and
20% GSCI
Portfolio III: 50% MSCI World,
50% Lehman Global Bond
Portfolio IV: 40% MSCI World,
40% Lehman Global Bond, and
20% GSCI
Source: CISDM (2005b).

Commodities as an Inflation hedge

Secondly, commodities are thought to be good hedge against unexpected inflation. However, we can not generalize this argument as different commodities have distinct characteristics from one another and thus have dissimilar drivers of returns. Therefore, in order to find out how effective different commodities are as inflation hedge we would need to look at each of them individually in order to test this hypothesis.

Chart 1



Gold

Gold is recognized as one of the most reliable hedges against inflation and the value of gold, in terms of the real goods and services it can buy, has remained largely stable. Indexed to 1900 prices, gold has held its value better than any other currency, as can be seen from the chart 1. All the major currencies, in terms of gold, have lost their value that depicts gold has captured loss in real value of these currencies, due to inflationary impact of the respective economies of those currencies. Whether the gold has yielded positive real returns we would need to look at a US centric example. If we take on the January 1980 price of USD 470/oz (average daily gold price between 1979 and 1981), the gold should rise to USD 1,400/oz (end-2012) to beat the inflation and retain the purchasing power. The gold in recent history has traded above this level, which depicts that gold has properties that make it a good inflation hedge over long periods.

Energy

Excluding gold, all other commodities have direct and/or indirect impact on the Consumer Price Index (CPI) calculation. Thus, an appreciating commodities market does cause price inflation in an economy. Oil for example is a component of nearly everything in the CPI basket. As per Federal Reserve Bank of San Francisco oil prices have a limited effect on core inflation in the U.S., although higher energy costs can get reflected directly in the CPI as consumers spend more money on gasoline, heating oil and the like. This impact will also be seen in the core CPI if prices rise and remain high for a period of time—because businesses will need to spend more money on their materials and inputs, which will then be passed on to the consumer in the form of higher prices. However, once oil prices stabilize, the corresponding inflationary pressures will dissipate. As a result, both overall and core measures of inflation may decline, with the overall inflation rate likely to fall towards the lower rate of core inflation. Thus, spike in energy cost will be reflected in the inflation number but in the short run CPI could be a more stable number whereas energy prices could be more erratic.

Agriculture

Agricultural products do reflect in the CPI calculation but it has been seen in the short term

that S&P GSCI Grains Index is much more susceptible to short-term supply and demand forces than inflationary forces. Thus, the argument remains the same that commodities could be erratic in the short term however, in the long-term price increases/decreases will be reflected in the inflation number.

Increased Popularity of Commodity Investing Worldwide

Large institutional investors—hedge funds, university endowments, defined benefit pension funds, and others— have long been able to hedge against or take advantage of changes in commodity prices through financial derivatives. For example, an institutional investor might invest in futures contracts on a particular commodity such as gold, silver, or oil. Individual investors pursuing portfolio diversification or wanting to hedge against inflation also may wish to accomplish those goals by investing in commodities. For retail investors, however, these strategies traditionally have been neither easily accessible nor cost effective. Using futures contracts to gain exposure to commodities requires expertise and active management. Given these factors, retail investors, until recently, typically only obtained commodity exposures indirectly—by buying shares in gold mining companies or by investing in mutual funds that bought shares in such companies. Until about a decade ago, there were no products designed specifically to allow retail investors to benefit directly from or to hedge against commodity price movements. The needs of retail investors have led to the creation of products that these investors can use to achieve exposure to commodity prices. The most popular and best-known products are commodity ETFs, commodity ETNs, and commodity mutual funds.

Assets under management (AUM), as depicted in table 2, has more than doubled between 2008 to 2012. Exchange traded products (ETP) segment have shown the most phenomenal growth that consists of closed-end funds, Exchange traded derivatives contracts and Exchange-traded funds. There has also been a phenomenal increase in AUM of precious metals, which has grown many folds since 2008.

Table 2

AUM (US $bn)	2012	2011	2010	2009	2008
Total Commodity AUM	424	395	380	271	160
Of which:					
Precious Metals	199	171	150	90	49
Base Metals	29	26	26	21	10
Agriculture	75	76	81	54	38
Energy	122	123	123	106	62

Source: Barclays 'The Commodity Refiner' April 2013.

HOW DO COMMODITY FUNDS OPERATE GLOBALLY?

Commodity funds take exposure to commodities via futures or swap contracts (swaps could also be thought of as series of future contracts on an underlying asset). Funds take an exposure in the commodities by posting a margin in the account whereas posting the remaining amount in short term money market placements.

The returns generated by funds come from three sources that are spot return, collateral return and roll return. The spot return is the return generated from changes in the price of underlying. Roll return is return generated by rolling futures contract forward that is, the return from selling the futures contracts as they approach expiration and buying the same contracts in a deferred month. The third source of returns comes from the short-term money market placements.

COMMODITIES BASED INVESTMENT IN PAKISTAN

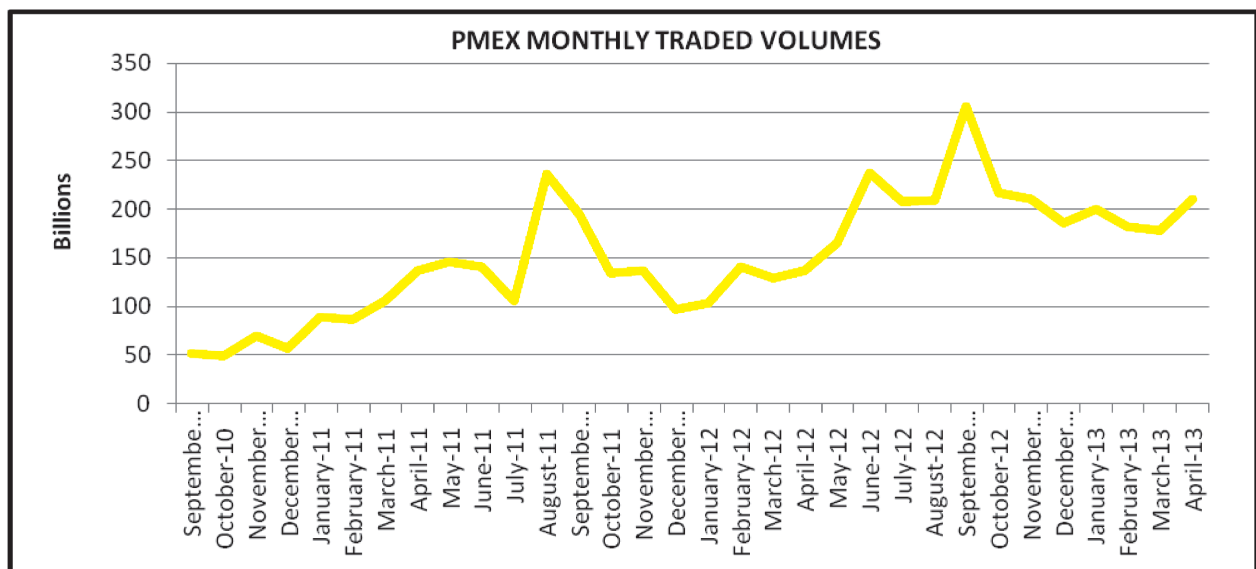
Commodity investment in Pakistan has increased many folds in recent years. Investors are moving away from the option of physical holdings in commodities by taking exposure via futures market through Pakistan Mercantile Exchange (PMEX). Even before the establishment of Pakistan's first futures exchange, forward hedging had been practiced by participants in various commodities. While often unregulated, they have nevertheless evolved their own trading protocols. Every time two parties enter into a transaction, they faced multiple

risks. These include non-delivery of payment or asset, defects in the underlying asset or differences in quality and issues of legal title. If these transactions were done through a central, neutral authority which takes upon itself the task of ensuring settlement then most of these risks can be eliminated. Such a third party in forward trading is actually called a Futures Exchange. The Exchange guarantees financial settlement of all trades and in order to discharge this responsibility, employs a multi-faceted risk management scheme.

Traded volume at PMEX has grown from September 2010 to almost four times till April 2013 as shown in chart 2. The surge in volumes shows that investors are taking exposure into various commodities such as gold crude oil, cotton, rice and silver. There are various other advantages of trading at PMEX, such as:

- Being central counterparty and clearinghouse, PMEX offers guaranteed financial settlement of all contracts traded on the exchange. In case of any counterparty defaults PMEX will step in to offset the contractual obligation;
- Trading liquid futures on an exchange removes the risks associated with bilateral, OTC trading: price unreliability, counterparty credit risk (guaranteed financial settlement), illiquidity (trading on the exchange);
- Trading commodities through PMEX gives the added benefit of earning return on cash margins posted with the exchange.

Chart 1



Source: PMEX

INTRODUCTION OF COMMODITY FUNDS IN PAKISTAN

Pakistan's mutual fund industry over the decade has witnessed surge in introduction of many open-end and closed-end mutual funds. The categories introduced include Equity Funds, Fixed Income Funds, Asset Allocation, Fund of Funds, Index Tracker, Money Market and Shariah-Compliant counterparts. The industry is still at its growth stage and compared to other developed markets the products offered are limited. Equity funds in the Pakistani market, only take form of Equity, Islamic Equity or Index Fund, globally, also include Large Cap, Mid Cap, Small Cap, Value, Growth and blended objective as well. There are numerous other products such as Tax-exempt, Real Estate, Sector, Market Neutral (Equity) funds amongst many others that are offered to investors. New products gets added on a regular basis that keeps the interest of investors alive and opens up avenues for new investors to invest in the mutual funds. Pakistani market since is still at its development stage, has room to develop and introduce new products that could prompt new investors to invest in the funds and could keep the interest of existing investors alive. Commodity fund is a step towards achievement of this goal as this could bring new investors to pool in their money. This could be a stepping-stone for the industry as it could initiate introduction of newer products in the Pakistani market. Increasing awareness of investors thus

posts an opportunity for the mutual fund industry to introduce products that could cater to the increasing appetite for commodities.

Due to presence of PMEX, AMCs have started to explore options of various types of mutual funds that will have exposure to commodities. It is important to realize that given the logistical and financial costs attached with physical holdings of commodities, most investment in this asset class is done through commodity futures contracts. It appears that the mutual fund industry is now poised to reach the next level in this asset class through various commodity fund design that are different in structure, risk profile and target market. Moreover, SECP, via Circular No.32 of 2012 and Circular No.6 of 2013, has introduced commodities as a new collective investment scheme in mutual funds and as a new sub-fund in Voluntary Pension System (VPS).

Advantages of Investing in Commodity Mutual Fund

Investment in mutual fund is liquid (could be redeemed/bought at any time during business hours). Physical holding can be illiquid and can be difficult to divest. Investment in mutual funds can be made in small amounts where as investment in physical commodities might not be easily divisible that makes investment in mutual funds convenient for small individual investors. This also saves investor storage cost, concern on security/theft and concern on purity/quality of commodities.

Furthermore, professional money managers have knowledge and competence to manage the investment in an efficient manner. They also have access to resources that an individual does not have, such as access to research reports, market information and databases, to make decisions that can bode well for the investment.

There is also a tax advantage of investing in commodity mutual funds. Tax credit could be availed on lower of amount invested in mutual fund or twenty percent of the taxable income of the Unit Holder. This could effectively lower your effective tax rate for the year. In addition, tax credit on voluntary pension scheme investment could be availed as well.

CONCLUSION

It is safe to assume that commodities will provide a hedge against the inflation in the longer term. Credit Suisse published a white paper in December 2010 that detailed its take on the matter. Their analysis showed that long-term investments in commodities have historically provided inflation-hedging benefits to investors. However, the foremost advantage of investing in commodities is that it helps increase risk adjusted return and thus has a place in an investor's portfolio.

Therefore, over the long run it does make sense to have commodities in ones portfolio. Similarly there has also been a growing interest in this asset class, that is not only limited to the Pakistani market, but is a popular means of investing all around the world. Given the rise in volumes at PMEX, depicting increased interest, introduction of Commodity Funds would help lift the AUM for the local mutual fund industry and would most likely be a catalyst to development of newer products in the future.

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