An approach on how to trade in commodities market

Last decade there emerged a new avenue for retail investors and traders to participate: this was the new modified electronic platform of commodity derivatives. For those who want to diversify their portfolios beyond shares, bonds and real estate, commodities emerged as an alternative tool and one of the best option across the globe.

Till some years ago, this wouldn't have made sense. For retail investors, they could have done very little to actually invest in commodities beyond gold and silver however the emergence of state of the art technology and methodologies it became possible to think beyond traditional asset class and invest or manage the risk in various other commodities like chana, oilseeds, crude oil and copper etc. in the futures market.

However, with the setting up of three multi-commodity exchanges in the country around 2003-04, market participants like traders, manufacturers, retail investors can now trade in commodity futures with or even without having physical stocks.

So first of all the question arises - what are commodities? In economics, a **Commodity** is a marketable item produced to satisfy wants or needs. In other words commodity is a raw material or primary agricultural product that can be bought and sold, such as copper or coffee.

Now the next question arises - what are **Commodity Markets**??? So the answer is any place where all raw or primary products are exchanged is called commodity market. Commodity markets can include direct physical trading and derivatives trading in the form of spot prices, forwards, futures and options.

Commodity Futures are contracts to buy/sell specific quantity of a particular commodity at a future date on an exchange platform . It is similar to the Index futures and Stock futures but the underlying happens to be commodities instead of Stocks and indices.

The Government of India permitted establishment of National-level Multi-Commodity exchanges in the year 2002 -03 and accordingly following exchanges have come into picture. They are

- ❖ Multi-Commodity Exchange of India Ltd, Mumbai (MCX).
- ❖ National Commodity and Derivatives Exchange of India, Mumbai(NCDEX).
- ❖ National Multi Commodity Exchange, Ahmedabad(NMCE).
- ❖ Indian Commodity Exchange (ICEX)
- ❖ ACE Derivatives & Commodity Exchange Ltd.

However, there are regional commodity exchanges also functioning all over the country with one or two commodities in hand.

At international level there are major commodity exchanges in USA, Japan and UK. Some of the most popular exchanges around the world are given below along with the major commodities traded:

Name Of Exchange	Major Commodities traded in exchange
New York Mercantile Exchange (NYMEX)	Crude Oil, Heating Oil
Chicago Board of Trade (CBOT)	Soy Oil, Soy Beans, Corn
London Metals Exchange (LME)	Aluminium, Copper, Tin, Lead, Zinc, Nickel

Chicago Board Option Exchange (CBOE)	Options on Energy, Interest rate
Tokyo Commodity Exchange (TCE)	Silver, Gold, Crude oil, Rubber
Malaysian Derivatives Exchange (MDEX)	Rubber, Soy Oil, Crude Palm Oil
Commodities Exchange (COMEX)	Gold, Silver, Platinum, Copper
Multi Commodity Exchange (MCX)	Gold, Silver, Crude Oil, Mentha,CPO, Copper, Zinc, Lead, Nickel etc
National Commodity & Derivative Exchange(NCDEX)	Chana, Soybean, Soy Oil, RM Seed, Pepper, Jeera, Turmeric, Chilli , Sugar etc

At Present futures are available on the following commodities.

Bullion	**Gold and Silver**
Oil & Oilseeds	*Castor seeds, Soy Seeds, Castor Oil, Refined Soy Oil,Soymeal,Crude Palm Oil
	Cotton seed, Oilcake, Cottonseed, Mentha oIl
Spices	Black Pepper, Red Chilli, Jeera, Turmeric, Cardamom, Coriander
Metals	Copper, Nickel,Steel, Zinc, Aluminium and Lead
Fibre	Kapas, Cotton
Pulses	Chana
Cereals	Wheat, Maize
Energy	Crude oil, Natural Gas
Others	Rubber, Sugar, Gur

*Since the exchanges continue to add new products, the above list may not show all commodities

Why Commodity Trading?

Commodity trading can be done for various purposes out of which two are most important

- Against the exposure towards physical trades -for risk management (Hedging)
- Having no exposure in physical form - Investment & Speculation

Hedging is the practice of offsetting the price risk inherent in any cash market position by taking an opposite position in the futures market. A long hedge involves buying futures contracts to protect against possible increasing prices of commodities. A short hedge involves selling futures contracts to protect against possible declining prices of commodities.

Speculation is the practice of engaging in risky financial transactions in an attempt to profit from short or medium term fluctuations in the market value of a tradable good such as a financial instrument ex-commodity

Basic instruction (How to trade)

The basic information that should be with the client is as follows:-

The process of the selection of the commodity depends on the knowledge and interest of the client regarding various commodities. It also depends on the amount of margin money means how much the client is interested to invest in commodity market. The selection of the commodity also depends on the time horizon (short, medium and long) for which the customer wants to go for investment in commodities. The choice of commodities is also based on the purpose for which customer want to go for investment like hedging, speculation or diversification.

Margin amount has to be deposited by both buyers and sellers of futures contracts through cheque. The purpose of collecting margin money by the exchange is to avoid the counter party risk of defaulting by its members or their clients in fulfilling their obligations. It is a part of the risk management system.

For conducting the process of trading the client can contact the dealer for knowing the price, movement and details regarding the amount required for doing a trade. For information on a particular commodity one has to generate interest in reading the fundamental reports coming out from the research desk.

The profit and loss of a trade depends on how correct you can identify the future trend of the price movement of that particular commodity. The loss can be controlled by putting a stop loss whenever you trade.

Why to Invest in Commodities?

The fact remains that commodities' trading is a robust, well regulated and a fast growing industry but as an investor why should one invest in it ?

1) They Can Help You Beat Inflation: Whenever you look at an investment you consider the returns that investment gives you and whether those returns beat inflation. We always crib about inflation; inflation means things getting expensive; products like pulses, oil, gold, silver, spices, cotton all keep on getting expensive. So when you invest in these commodities through futures trading, you are effectively beating inflation. Gold is considered as an important hedge against inflation.

2) ***Diversification of Your Portfolio:*** All financial planners, financial blogs and magazines advise you diversify your portfolio and commodities are a great way to do so. They have a high return capacity just like equities and you have an option other than equity that can help you earn big returns. To diversify your investment portfolio, you may look to invest in E-Gold i.e., in Spot Market (NSEL) or in Futures Market or you can also go for investing through arbitrage (The simultaneous purchase and sale of similar commodities in different markets to take advantage of a price discrepancy.)

3) ***Hedging of Risks:*** During a disaster like war, drought, flood, political uncertainty etc the commodities react differently from other investment classes. These situations may cause a shortage of products and increase in demand of certain products thereby pushing the commodities price up and giving you an option to hedge your risk. Secondly participants who are exposed to commodities in physical form, they always carry the price risk. To reduce this price risk futures is one of the financial tool available in the market.

4) ***Surplus fund:*** To park the surplus amount of fund which one wants to invest, then one of the options available for him/her is commodities.

Another advantage of trading in commodities is high financial leverage. Margin required for trading in commodities (except in spot trading where complete cash is required) is less; it ranges between 5-15% whereas for equity trading it is between 10-25%.

So if Rama buys a silver future and the margin for the same is 7%; by investing Rs. 7000 she can buy a futures contract worth Rs. 100,000. If the price of silver increases by 5% then she has the potential of earning Rs. 5000 by investing Rs. 7000. This can especially be beneficial

for small investors who do not have a large amount to block for investments. However there is a risk of price movement on the down side too if position has been taken without having correct information. Therefore there has to be always a STOP LOSS for the trades executed to contain the downward risk if it's not hedged.

How does it work???

As in the case of stock futures, you don't have to pay the entire amount, just a fixed percentage of the cost of the commodity which is known as initial margin can be paid to take a position or trade in the commodity futures market.

Let's say you are buying a Gold Futures contract of 100 g. 100 gms of gold may be worth Rs. 2,80,000/-.The margin for gold set by the Exchange is 4 to 5%. So you only end up paying Rs. 14,000/-.The low margin means that you can buy futures representing a large amount of gold by paying only a fraction of the price. So you bought the Gold Futures contract when it was Rs 28000 per 10 gms. The next day, the price of gold rose to Rs 28500 per 10 gms. Then Rs.500 (Rs 28500 - Rs 28000) will be credited to your account. The following day, the price dips to Rs 27500.Rs 500 will get debited from your account (Rs 28000 – Rs 27500). This profit or loss is called Mark to Market. In this way trade happens.

At the end of every trading day, the margin account of the trader/client is adjusted to reflect the participant's gain or loss. These price variations are netted into the daily margin account.

Risk that should be kept in mind while trading?

Different kinds of risks faced by participants in derivatives markets are:

- Credit Risk (Credit risk on account of default by counter party: This is very low or almost zero because the Exchange takes on the responsibility for the performance of contracts)
- Market Risk (the risk of loss on account of adverse movement of price.)
- Liquidity Risk (the risk that unwinding of transactions may be difficult, if the market is illiquid)
- Legal Risk (legal objections might be raised; regulatory framework might disallow some activities.)
- Operational Risk (the risk arising out of some operational difficulties, like, failure of connectivity, electricity or banking problems etc, due to which it becomes difficult to operate in the market.)

How risky are these markets compared to stock & bond markets?

-
- Commodity prices are generally less volatile than the stocks and this has been statistically proven. Therefore it's relatively safer to trade in commodities.
- Also the regulatory authorities ensure through continuous vigil that the commodity prices are market-driven and free from manipulations.
- However, all investments are subject to market risk and depend on the individual decision. There is risk of loss while trading in commodity futures like any other financial instruments.
- Also the client should use Stop loss as a precautionary measure according to the risk appetite. The client should be aware of the amount of the risk he or she can absorb as sometimes market becomes volatile or move in opposite direction.

What is the minimum investment needed?

You can start your investment with an amount as low as say Rs 25,000. All you need is money for margins payable upfront to exchanges through brokers. Generally commodity futures require an initial margin between 5-10% of the contract value. The exchanges levy higher additional margin in case of excess volatility. The margin amount varies between exchanges and commodities. Therefore they provide great benefits of leverage in comparison to the stock traded on the stock exchanges. The exchange also requires the daily profits and losses to be paid in/out on open positions (Mark to Market or MTM) so that the buyers and sellers do not carry a risk of not more than one day.

Do I have to give delivery or settle in cash?

You can do both however as per the guidelines of the exchanges. Some commodities are cash settled while rest are compulsory deliverables. The choice is yours. If you want your contract to be cash settled, you have to pre close the positions before the delivery period.

If you plan to take or make delivery, you need to have the required warehouse receipts (demated or without demat as per the exchange guidelines) in the case of seller while in the case of the buyer pay in has to be complete to take the delivery. Once decided same needs to be informed in advance to your member (broker). The option to settle in cash or through delivery can be changed as many times as one wants till the start of the delivery period of the contract.

What do I need to start trading in commodity futures?

You have to open an account by filling up Know Your Customer (KYC) application with a broker and margin will have to be given to the broker to start the trading. If you are looking for deliveries also then in addition to the trading account you need to have a separate commodity demat account from the National Securities Depository Ltd (NSDL) or Central Depository Securities Ltd (CDSL) just like in stocks. Besides you will need to give you details such as PAN no., bank account no and cheque, address proof etc.

Who regulates the commodity exchanges?

Just as SEBI regulates the stock exchanges, commodity exchanges are regulated by Forward Markets Commission (FMC); Forwards Market Commission works under the purview of the Ministry of Food, Civil supplies and Public Distribution.

Are there physical deliveries in commodity futures exchanges?

YES, the exchanges, in order to maintain the futures prices in line with the spot market, have made available provisions of settlement of contracts by physical delivery. They also make sure that the price of futures and spot prices coincide during the settlement so that the arbitrage opportunities do not exist.

How the deliveries are made possible?

The exchange has enlisted certain cities for specific commodities as the delivery centres. The seller of commodity futures may choose to deliver physical stock instead of settling the positions by cash, in which case he would be required to deliver the stocks to the specified warehouses as per the contract quality specifications. The buyer of the commodity futures, if he is interested in physical delivery would be matched with a seller and would be required to take delivery of the specified quantity of stock from the designated warehouse.

World-wide commodity futures are generally used for hedging and speculation and hence physical deliveries are negligible. However, the possibility of physical delivery has made these markets more attractive in India. Both NCDEX and MCX have successfully completed physical delivery in bullions and various agro-commodities.

Who benefits from dealing in commodity futures and how?

Commodity futures are beneficial to a large section of the society, be it farmer, businessmen, industrialist, importer, exporter, consumer.

If you are an investor, commodities futures represent a good form of investment because of the following reasons.

- **Diversification** The returns from commodities market are free from the direct influence of the equity and debt market, which means that they are capable of being used as effective hedging instruments providing better diversification.
- **Less Manipulations** - Commodities markets, as they are governed by international price movements are less prone to rigging or price manipulations by individuals
- **High Leverage** The margins in the commodity futures market are less than the F&O section of the equity market.

If you are an importer or an exporter, commodities futures can help you in the following ways…

- **Hedge against price fluctuations -** Wide fluctuations in the prices of import or export products can directly affect your bottom-line as the price at which you import/export is fixed before-hand. Commodity futures help you to procure or sell the commodities at a price decided months before the actual transaction, thereby ironing out any fluctuation in prices that happen subsequently.

If you are a producer of a commodity, futures can help you as follows:

- **Lock-in the price for your produce-** If you are a farmer, there is every chance that the price of your produce may come down drastically at the time of harvest. By taking positions in commodity futures you can effectively lock-in the price at which you wish to sell your produce
- **Assured demand**- Any glut in the market can make you wait unendingly for a buyer. Selling commodity futures contract can give you assured demand at the time of harvest.
- **Increase in holding power**- You can store the underlying commodity in exchange approved warehouse and sell in the futures to realize the future value of the commodity.

If you are a large scale consumer of a product, here is how this market can help you:

- **Control your cost-** If you are an industrialist, the raw material cost dictates the final price of your output. Any sudden rise in the price of raw materials can compel you to pass on the hike to your customers and make your products unattractive in the market. By buying commodity futures, you can fix the price of your raw material.

- **Ensure continuous supply** Any shortfall in the supply of raw materials can stall your production and make you default on your sale obligations. You can avoid this risk by buying a commodity futures contract by which you are assured of supply of a fixed quantity of materials at a pre-decided price at the fixed time.