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Mutual Funds and Portfolio Managers in Commodity Derivatives Segment

Why in news?

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SEBI has put forth proposals to allow mutual funds and portfolio managers to invest in commodity derivatives segment.

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What are Commodity Derivatives?

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- **Derivatives** - Derivative is a contract between two or more parties.
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- Its value is determined by the underlying asset.
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- The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.
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- **Commodity Derivatives** - It's a derivative contract with a commodity as the underlying asset.
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- Producers who want to manage the risk of future price uncertainty for their commodities enter into commodity derivatives.
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- In India, like a stock market NSE provides a platform to trade in different shares, the Multi Commodity Exchange (MCX) and National commodity derivative Exchange (NCDEX) facilitate for the commodities.
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- MCX is known for the trading of Bullions metals (Gold, Silver, etc), Base Metals (Zinc, Aluminium, etc) and Energy (Crude Oil and Natural Gas).
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- The NCDEX is known for trading in Derivative contract of agricultural produces.
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What are Mutual Funds and Portfolio Managers?

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- **Mutual Fund** (MF) is an investment vehicle made up of a pool of moneys collected from public investors.
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- The pooled money is used to buy other securities by professional money managers.
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- They give small or individual investors access to professionally managed portfolios of equities, bonds and other securities.
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- **Portfolio Manager** (PM) is a professional person or a group of people, usually experienced investors responsible for making investment decisions on behalf of individuals or institutions.
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- The main difference between MFs and PMs is that in Mutual Funds, the investors' money is pooled and collectively invested, which is not the case with PMs.
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What is SEBI's recent proposal?

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- As of now, only gold is a permissible commodity for institutional investors, and is allowed through exchange-traded funds (ETFs).
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- SEBI had earlier attempted to increase the institutional participation in the commodity segment.
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- E.g. It recently allowed category -III *Alternative Investment Funds* (AIFs) to participate in the commodity derivatives market.
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- In line with this, allowing mutual funds and portfolio managers in the commodity derivatives segment aims at broadbasing the commodity derivative segment.
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- SEBI's Commodity Derivatives Advisory Committee (CDAC) has also suggested opening up the market to both domestic and foreign institutional investors in a phased manner.
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What are the benefits?

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- The Indian commodity derivatives market was lacking the desired liquidity and depth as it was running without any institutional participation.
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- The current move fills this gap and hence brings in efficient price discovery and price risk management.
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- There is also a huge surge in Mutual Funds in recent periods, indicative of widening base of investors.
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- So allowing MFs and PMs in the commodities segment comes as an additional or alternative asset class for diversification.
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- It is also in line with the series of liberalization measures in the past couple of years for investors to increase participation in domestic institutions.
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What are the cautionary steps to be taken?

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- **Risks** - SEBI has said that the overall risk adjusted return of the portfolio might improve.
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- Nevertheless, adequate checks and balances will have to be put in place before implementation.
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- **Investors' Money** - Commodities prices tend to fluctuate violently.
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- Hence, Mutual funds, being custodians of investors' money, will need to be extra cautious while investing in them.
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- SEBI has to ensure that scams like the one involving the National Spot Exchange Limited (NSEL) do not recur.
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- **Level Paying** - Facilitating greater participation by retail investors and small commodity producers in this market is essential.
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- **Regulation** – MFs and SEBI need to appreciate that commodity derivatives and shares are totally dissimilar objects.
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- They thus demand different expertise and skills for trading, as also for monitoring and effective regulation.
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Quick Facts

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Alternative Investment Funds

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- An alternative investment is an asset that is not one of the conventional investment types, such as stocks, bonds and cash.
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- Alternative investments include private equity, hedge funds, managed futures, real estate, commodities and derivatives contracts.
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- Most alternative investment assets are held by institutional investors or accredited, high-net-worth individuals because of the complex natures and limited regulations of the investments.
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Source: Business Standard

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