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P R I S T I N E

Alternative Investment

Key Issues in Investing in Commodities

- Contango and Backwardation
- Risk and Return on Commodity Investment
- Commodity Index Strategy

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Sample Material

Contango and Backwardation

- **Contango** refers to a situation where the future price is above the spot price. This happens when the prices are expected to increase and most hedgers in the market are people going long on the futures contract.
- **Backwardation** refers to a situation where the future price is below the spot price. This happens when most of the traders are producers of the commodity trying to hedge their positions from an expected fall in the prices.

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Risk and Returns

- The return on commodities depends on the movement of the prices of the commodities.
- Taking long term positions on derivatives will require rolling over the short term contracts as and when they expire. Rolling forward contracts may result in a gain or loss which is known as the **rolling yield**. For future prices in backwardation, the investor will have a positive roll yield.
- Sometimes treasury bonds are deposited as a collateral for entering into a future/forward contract in commodities. In such case the yield is the yield on treasury securities known as the **collateral yield**.

Commodity Index Strategy

- Commodity Index Strategy is not a passive strategy as the Equity Index Strategy.
- The manager will have to actively manage when to roll over their open futures/forwards. This decision will depend on the effect it has on the roll yield.
- As commodity index weightings keep changing over time, the manager ensure that the exposure is appropriate at the time of each roll over.
- The manager also need to keep track of the collateral yield as and when they mature and replace them.

Example

- A passive manager purchases a position worth \$50 million in underlying value of a futures contract, The manager also buys \$50 million worth of 10-year U.S. Treasury notes at par that pay an interest rate of 5%. Compute the gain in the value of the position if, at the end of one year, the futures contract position is worth \$51 million and the price of the 10-year notes is unchanged.

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