Standard Chartered

Commodities investment

Know your options, manage your risks

Events over the past three years have generated extreme levels of volatility in the commodities arena. In this article, Standard Chartered provides companies and investors with some keen advice on hedging against these sharp moves, and the clear advantages of commodities investment over the long term

Commodity prices have witnessed extreme levels of volatility during the past three years. What are the best techniques for companies and investors to hedge against the most extreme elements of these price moves?

Arun Murthy, Global Head of Commodities Trading: I think all clients need to pursue a systematic hedging strategy. I would suggest that you have at least 20–30% of your base risk hedged with vanilla structures and the balance of 20–30% with a mixture of vanilla and exotic structures depending on how savvy the client is and what hedging policy they have. The main thing is not to game or time the market, because you can never pick the bottom or the top. We've seen cases where clients have not taken advantage of market dips or corrections. It is useful to have some targets in mind and execute accordingly.

Ashish Mittal, Global Head of Commodities Sales: I believe it is important to benchmark yourself against your cost of production or your budgeted rate, whether you're a producer or a consumer. Once that is done, then you are better off working on a systematic and consistent strategy, so that – even though you might not gain every year – on an overall basis you'll come out much better as a company.

Can you explain a little more about what this involves? What about using derivatives?

Mittal: The question to ask is, what instruments do you want to use and how are you going to manage the related risk? A combination of vanilla and non-vanilla instruments would probably give you the best result, as long as you align the payoffs with your cost of production or budgeted rates. Non-vanilla structures could be simple option-based structures or quite exotic in nature. However, clients don't need to get into exotic structures if they don't understand the related risk versus reward. As long as you understand and factor in the downside risk, non-vanilla structures can at times give you a better hedge than vanilla structures.

Ashish Mittal Arun Murthy

Murthy: In exotic structures, what you get are enhanced strikes or better entry levels. What you give up, though, may be the upside or you may risk your downside to a much greater level. As a bank, we always assess the experience and comfort level of our clients. We are in constant discussion with them on their specific needs, explaining to them exactly what the risks are in doing certain structures. We will make an assessment of the situation and provide what's best for our clients.

One trend during the past 18 months has been a shift from structured hedging solutions to shorter-dated, more vanilla hedging. What are the pros and cons of this approach?

Mittal: After the crisis, we saw a shift towards the usage of vanilla trades, but over the past few months we've seen some interest in non-vanilla structures given that they are likely to give a better payoff. However, there is a higher level of due diligence with clients avoiding leveraged and highly exotic trades. Overall, we are getting a better balance between vanilla and non-vanilla transactions. Clients are making a conscious effort to avoid the mistakes made during 2008 and 2009.

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Murthy: I think what is happening here is that clients are moving away from leveraged into non-leveraged products, less so from exotics into vanilla, because you can have leverage in both products. Instead of thinking about the pros and cons, they should actually be thinking about the risk rewards. If you employ leverage, you enhance your strike and get better values, but increase your risk too. Your risk is less if you do non-leveraged structures, but your entry or strike levels are at market. Hence, I find it is more about thinking of risks and rewards rather than pros and cons, and that the movement is more between leveraged into non-leveraged products and not so much from vanilla into exotic products.

PRODUCTION

Should commodity companies – whether producers or users – sell options?

Murthy: I don't think they should sell naked options. For instance, if a producer sells a naked call, what he's doing is collecting premium and capping his upside. A better strategy would be for him to do collars where he floors his downside as well. In general, naked selling of options has not been a good strategy and we always advise clients of tail-risk events.

Mittal: Selling options over a long run is more often than not a losing proposition. If a client just keeps selling options, then at some stage, when the market moves against him, he is likely to lose a lot more than what he would have gained. So I don't think selling options is the right strategy on a standalone basis. We haven't really seen it amongst our client base and it's something that we discourage as well.

How can banks such as Standard Chartered help miners and other companies with commodity exposures with their financing needs?

Mittal: Standard Chartered Bank has deep expertise in Asia, Africa and the Middle East. The commodities team works very closely with other areas of the bank such as project finance and structured trade finance in identifying appropriate solutions for clients in our markets. These not only address their financing needs but also enable them to hedge their exposures, thus ensuring much better visibility around future cash flows and profitability.

There is some traction in the shift from take-or-pay pricing, which has caused deep divisions among raw material producers and consumers, to index-linked contracts. How would you assess progress in this area? Are markets sufficiently deep to enable a liquid derivatives and hedging market?

Murthy: A lot of these gas contracts or electricity contracts have moved from a fixed-price take-or-pay basis to something that is index-linked – for instance, a 20-year index-linked gas contract. The question we should ask is whether the derivatives market is deep enough to hedge a 20-year liquefied natural gas or coal contract. I think it's not deep enough to do this yet. I think the derivatives market can handle a seven- to 10-year hedge. My view though is that a lot of these take-or-pay fixed-priced contracts will start getting more index-linked and for shorter tenors, which could then create an environment with an increased demand for hedging. Given the way the commodity markets have transformed in the past 15 years, I would not be surprised if we see more commodities and commodity indexes trade out to several years.

Mittal: One of the advantages of indexing is that you are able to separate your price risk from your physical risk. This is because, once you get into a long-term fixed-price contract and as the price moves over the life of the trade, the counterparty that comes 'in the money' could end up taking a significant risk on the counterparty that is 'out of the money'. From a financial perspective, it is best to segregate the physical risk from the price risk, and then manage the price risk separately. As long as you're selling or buying the physical on an indexed basis, even if one of the counterparties was to default, the other counterparty, in most instances, can find a substitute for the physical trade. Thus, by managing the price risk separately, the organisation is not being put at risk. This element will continue to provide a momentum towards developing a deeper and more liquid market. Iron ore is a very interesting example; the market is moving rapidly from term contracts to quarterly resets. There is push-back from some of the bigger consumers, for example, the steel mills, as their preference is for yearly contracts where prices are fixed and not subject to variations. However, there is a real reluctance to move back into the yearly fixed-price mechanism and I think this market will evolve and develop. The coal market is already quite liquid, and certainly iron ore is moving rapidly in that direction.

Investors are once more eyeing commodity investments. What are some of the best ways to access commodity investments for first-time buyers? Specifically, what are the major risks and returns?

Murthy: Anyone who wants to invest in commodities must have a long-term and not a short-term view. Investors first need to learn what is available – you have passive indexes, which have a mechanism whereby they roll their futures contracts on a monthly basis. Because they're passive the fees are low, but the risk in all these passive investments is the negative roll yield. With the markets now in contango, any passive index is experiencing a negative roll yield, so you're not going to get as much enhancement. Nowadays, you can also find some indexes that have roll yields that are enhanced; they're a bit more actively managed. If you're a little bit more of a savvy investor, then we would recommend going for a more active index or active fund. These are long-short funds with long-short positions, managed by active fund managers who can make money when markets go up or down. The fees are generally going to be much higher.

I think the best way for an investor is to sit down with an adviser and go through some analysis and back-testing, see how the returns have been on the different types of products and make a more informed decision that way.