

# Commodities Stake Their Claim

**At this stage of the equity market cycle, are commodity structured products well-placed to find favour with private clients in Asia?**

Written by Andrew Crooke

**AS THE SPOTLIGHT** focuses on what many product manufacturers and private banks recognise as an over-concentration on a limited number of equity-linked structured products, there is growing interest in developing structures based on underlyings such as commodities.

In some cases this tallies with requests for more information from private clients on what their options are; they too realise the growing need for diversification as the equities bull-run enters a more mature phase.

Interest in commodities from Standard Chartered's perspective, for example, has risen dramatically over the past few years, as investors seek to diversify their existing portfolios.

"We are actively involved in these markets and this is certainly an area we expect to continue to grow, particularly in the private banking space," says Stephen Richards Evans, managing director and head of Standard Chartered Private Bank in Greater China.

Similar sentiment can be heard from some other private banks in Asia, with at least two

of them who were interviewed for this article saying — on an anonymous basis — that they are looking to set up dedicated teams internally to help build a commodity structured products business.

#### **Why is Investor Interest Growing?**

Commodity structured products provide two main opportunities: to invest directly in the forward curve and take advantage of these risks when designing products; and to invest via an Index designed to remove risk associated with the forward curve.

For manufacturers, it is beneficial to be opportunistic in product design, react quickly to market conditions, and split trades into tranches and use Asian features, says David Burns, London-based head of commodities markets at Commerzbank.

"In general, commodities are a good asset class for investment," he explains. "Current market conditions are giving rise to some excellent investment opportunities, and at the same time, de-correlation with other asset classes reduces portfolio volatility and increases returns." As a result, he adds,

there are benefits in taking an opportunistic approach.

Indeed, investors in Asia want exposure to the commodity markets. "Some of them have been seeing in the media that soft commodities are in favour and that prices are going up, and they want to participate," says Thomas Hugger, executive director and head of investment at LGT Investment Management in Hong Kong.

Until now, however, many of LGT's clients only really know about precious metals, and a bit about energy. "It is a new concept for many investors and it is difficult for them to get that kind of exposure through the domestic or retail banks; so they come to the private banks to ask for recommendation and investment advice."

In particular, after the sub-prime meltdown in August, investors were afraid of the potential contagion effect on equities, funds and fixed



income, said Jacob Doo, head of structured products at Bank Julius Baer & Co.

“There was a brief moment where credit spreads widened, especially for financials,” he explains. “Investors therefore had to look for alternatives and commodity as an asset class appeared to be the logical investment as a hedge against the turn of events, given its low correlation traditionally.”

According to Richards Evans, popular investments include: broad indices such as GSCI or the DJCRB index, or sub-baskets such as agricultural, metals or energy; commodity-specific investments such as bull and bear notes, range accrual structures linked to individual commodities — gold, crude oil, base metals — or basket of commodities; and theme paper-plays on the bio fuel market — corn, sugar, palm oil.

Doo at Bank Julius Baer says that some of the most popular products among his client base are principal protected Shark Note or Wedding Cake structures on Gold and / or WTI with a tenor of between six and 18 months.

Meanwhile, Hugger says that most of his clients want to get exposure to participate in the commodities markets with some downside protection.

#### **What are the Right Product?**

Part of the problem previously with many non-traditional asset classes, including property, commodities and high-yield



**Thomas Hugger**  
LGT Investment Management

to effectively sell volatility through a reverse convertible structure.

A classic example of this strategy may have been found in the wake of the Amaranth debacle, he explains: natural gas prices fell 70 per cent peak to trough, driving implied volatility to a level allowing a 30 per cent out of the money one-year put to be sold for 20 per cent+ simple return. “This is a very attractive, opportunistic type of non-flow investment that requires considerable patience to identify and is the type of opportunity our investment advisory group at the Standard Chartered Private Bank would seek to highlight.”

Another approach, he says, is to focus on less volatile commodities with lower overall correlation — primarily soft or other agricultural commodities.

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**– Thomas Hugger, LGT Investment Management**

currencies for example, has been their increasing correlation with equity markets.

So in order to gain real diversification and reduce overall equity correlation, structures based on longer term growth/inflation assets such as metals and energy need to focus on capturing short-term volatility, explains Richards Evans. “The longer-dated the products, the more highly correlated they will become with global demand, and therefore with stock markets.”

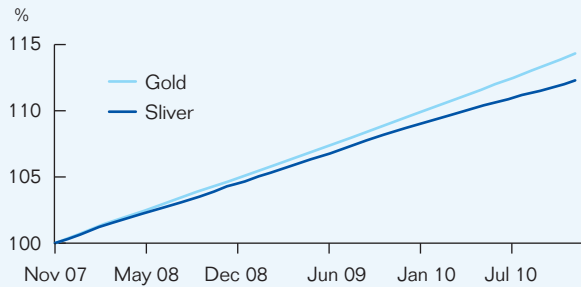
One solution is to focus on the most volatile commodities after big moves and

However, lower volatility generally means lower likelihood of callability. “We therefore tend to see products that focus on a basket of softs rather than a single commodity, and with fairly modest medium-term projected returns,” explains Richards Evans. “The exception to this rule has been wheat, which has soared just 50 per cent in three months with 30-day volatility approaching 40 per cent.”

He adds: “It should be observed that, despite this tremendous rise in both price and price movement, wheat has been less mercurial than the Chinese asset markets, the rise of which has no doubt contributed to pressure on wheat and other food grains, thus eroding the ability to de-correlate



## Precious Metals

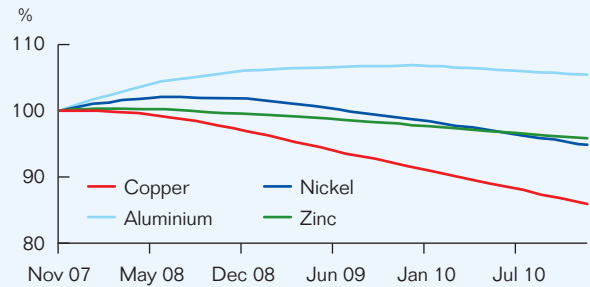


ATM Volatility	6m	1y	5y
Gold	18.7%	18.2%	18.3%
Silver	29.1%	29.1%	29.3%

- Market behaves in similar manner to equities
- Forward curve is determined by arbitrage
- Low volatility
- Reference price is spot
- Gold \$1m ~ 0.0022 m<sup>3</sup>  
(the size of a 2 litre bottle of Cola)

Source: Commerzbank Corporates & Markets

## Industrial Metals



ATM Volatility	6m	1y	5y
Copper	28.5%	28.5%	26.8%
Aluminium	20.6%	20.3%	16.2%
Nickel	44.8%	43.2%	34.1%
Zinc	30.2%	29.6%	25.9%

- Arbitrage of contango is possible
- Arbitrage of backwardation is not
- Generally higher volatility
- Reference price is spot
- Forward curve often in backwardation due to hedging
- Copper \$1m ~ 16 m<sup>3</sup> (the size of a car)

Source: Commerzbank Corporates & Markets

returns for clients with high Chinese equity exposure."

However, given the very high velocity of money in today's markets, private clients don't always have enough patience to wait for the first type of opportunity and would rather simply capture short-term volatility.

"We are finding that the client base is very much bifurcated in terms of risk appetite in terms of how this strategy is executed in

the structured products universe," says Richards Evans. "Those clients with a trading mentality or with a strong conceptual understanding of risk will tend to focus on short-dated reverse convertible structures, callable range accrual notes or callable directional (bull/bear) notes."

On the other hand, he adds, more risk-averse clients tend to focus on either defined-return products such as shorter-

dated Wedding Cake structures or to use a CPPI structure to provide managed risk exposure to a Commodity Trading Advisor (CTA) such as Winton or AHL.

### Is Demand Sustainable?

While with many kinds of structured product there is an element of clients buying the flavour of the month, in terms of commodities, there is a reasonable growth potential because there has been a general increase in awareness of the associated

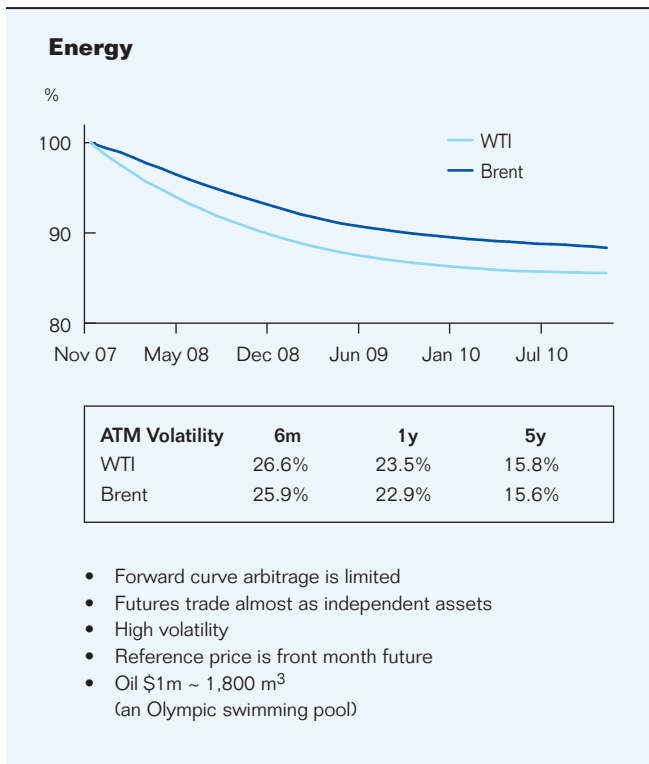
## Using an Index

According to Commerzbank's David Burns, a commodity Index can be any index designed to track commodity prices. This is often published as a series of indices, including a general commodity index and sub-indices designed to track specific sectors of the commodity market.

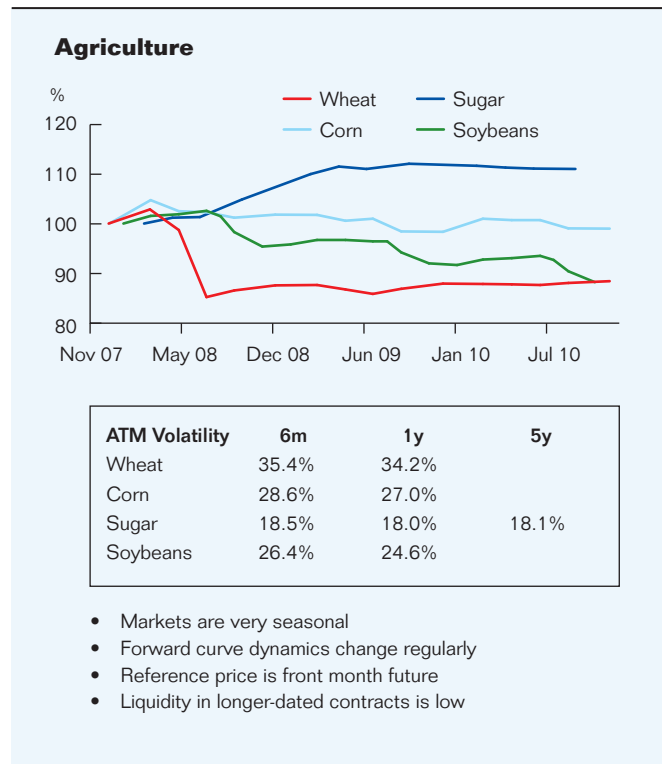
"Such an index is usually futures based to avoid the difficulties in holding physical assets, has a predetermined "rolling" schedule, and maintains a constant cash exposure to the underlying contracts during rolls," he explains.

Benefits of an index include a flat forward curve, the same daily index returns as nearby futures, and the possibility of longer maturities for structured transactions

"Typically, passive commodity investors tend to get long via an index," says Burns. "However, in our experience roughly equal numbers of structured product investors go short as go long. We also see a good degree of secondary market flow in our structured products as investors react opportunistically to the markets, and take profits."



Source: Commerzbank Corporates & Markets



Source: Commerzbank Corporates & Markets

opportunities — something which Hugger predicts will remain for the time being.

“I see these products being mainly sought after by high net worth investors, rather than mass affluent sector,” says Hugger.

“However,” he adds, “I don’t think that commodities will have the same appeal for private clients as other asset classes such as hedge funds over the long term, since hedge funds are a kind of absolute return product.”

Education generally is one challenge, especially for soft commodities and some kinds of energy. “We need to explain how the structures work and the pitfalls of, as well as differences between, an excess return index and a total return index,” he says.

At the same time, given that familiarity is a key factor influencing a client’s buying decision when it comes to commodity structured products, providing education and research access to clients — to give them a better appreciation of the fundamentals on commodity markets — is one way private banks can position themselves to tap this market.

“The investment into commodity structures with either gold or WTI as the underlying is greater because clients could get the information readily from many channels,” explains Doo. “But if the underlying is a soft

“In addition, complexity will kill the interest,” he warns. “Investment from private individuals will not be as great as the amount we see on the equity and interest rate side.”

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– David Burns, Commerzbank

commodity such as soya beans or wheat, there is a general reluctance because few investors can associate themselves with the fundamentals. In between the two groups lie the base metals.”

When it comes to getting clients comfortable with investing, one potential area of concern for them is performance.

In comparison with commodity products, investors had been buying interest rate and equity structures in recent years, mainly accumulators, and as a result are comfortable with the performance of these structures, explains Doo.

Another client concern Hugger identifies relates to the tenor of product. “With some commodity structured products, clients really have to hold them until maturity to get full participation, and this is one concern.”

Structures which are simple to explain and understand are therefore highly sought after.

If all this can be achieved, private bankers say there is clearly potential for growth in this space in Asia. With greater comfort, commodity products could account for about 5 per cent of a portfolio. ■