Invest in commodity to offset inflation risk

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advantages

LEVERAGE : Commodity futures operate on margin, meaning that to take a position only a fraction of the total value needs to be available in cash in the trading account.

COMMISSION COSTS : It is a lot cheaper to buy/sell one futures contract than to buy/sell the underlying instrument.

ABILITY TO GO SHORT : Futures contracts can be sold as easily as they are bought enabling a speculator to profit from falling markets as well as rising ones. There is no uptick rule for example like there is with stocks.

OVER THE last few months, inflation concerns have been at the top of everybody's mind, with both the government and RBI unveiling multiple measures to try to control it. The concern has now become more widespread, with prices of agricultural commodities at multi-year-highs and higher prices of oil on the back of the Middle East tensions starting to create concerns of a growth slowdown in India.

Considering the significant short term impact that inflationary concerns are having on Indian equity markets, coupled with concerns on higher interest rates and higher commodity prices, investor portfolios may need to get realigned to the reality of higher inflation over the next few quarters. So far, inflationary concerns have largely been limited to India, China and some parts of Asia but inflation could start to become a concern in the developed world from the second half of this year as well.

Adding commodities to portfolios tends to be a good solution to hedge against higher inflation, and also tends to have low correlation with other asset classes over long periods of time. Commodities can largely be bought through the use of commodity futures wherein investors buy commodities through a commodity exchange or through managed products including international mutual funds and exchange traded funds. Since products on the commodity exchange tend to be margin products most of the time and could involve some degree of leverage, investors need to be careful about the use of these products.

Commodity exposure can largely be taken in portfolios through the use of different types of commodities, namely —

- Agricultural commodities — Agricultural commodities are available either through the use of commodity futures wherein specific commodities can be purchased on the commodity exchange, or through the use of agricultural funds available overseas. Agricultural funds available overseas tend to invest in stocks of agriculture linked businesses.
- Precious metals — Gold is the most popular investment in this category and can be bought through Exchange Traded Funds (ETFs) or gold mutual funds, which either invest in gold ETFs or in stocks of gold mining companies. Of course, physical gold purchases are also an option though they have a disadvantage to other options in terms of purity control, taxation and storage. Silver is also a popular option wherein you can either explore the option of buying silver on a commodity exchange or an international silver ETF.
- Industrial commodities — These include commodities like copper, zinc, tin, etc and can be bought either through a commodity exchange or through the use of international mutual funds that invest in shares of industrial commodity businesses.

Since commodities tend to be very volatile and are also at multi year highs in many cases, the exposure should be built gradually, and not exceeding 10 per cent of the overall portfolio. International exposure also involves currency risk that investors need to be aware about.

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