MANAGING COMMODITY RISKS

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As we discussed in our previous blog on understanding commodities, futures contracts are the most common way to invest in commodities that one does not wish to take delivery of and store. For markets like oil, contracts are available with expiration dates for every month of the year. Contracts may be available in 1-month, 3-month, 6-month, 12-month, 18-month and longer expirations.

Depending on the direction of futures prices in relation to their current spot prices, commodity markets can be in contango or backwardation (see figure 1).

- A commodity is said to be in contango when the price of a distant futures contract is higher than the price of a nearer future one.
- A commodity is said to be in backwardation when the price of a distant futures contract is lower than the price of a nearer future one.

Risks and opportunities

Both market conditions include opportunities and risks. In contango, the risk is that as you roll contracts into new ones, you may have to accept less for the contracts you are selling and pay more to buy the same number of contracts. The shorter the contract term, the more frequent you realise the cost (or benefit) of rolling your futures contract.

Similarly, when markets are in backwardation, there is a risk that you may not benefit from price increases that occur in the shorter term if you are in longer term contracts.

ETP strategies

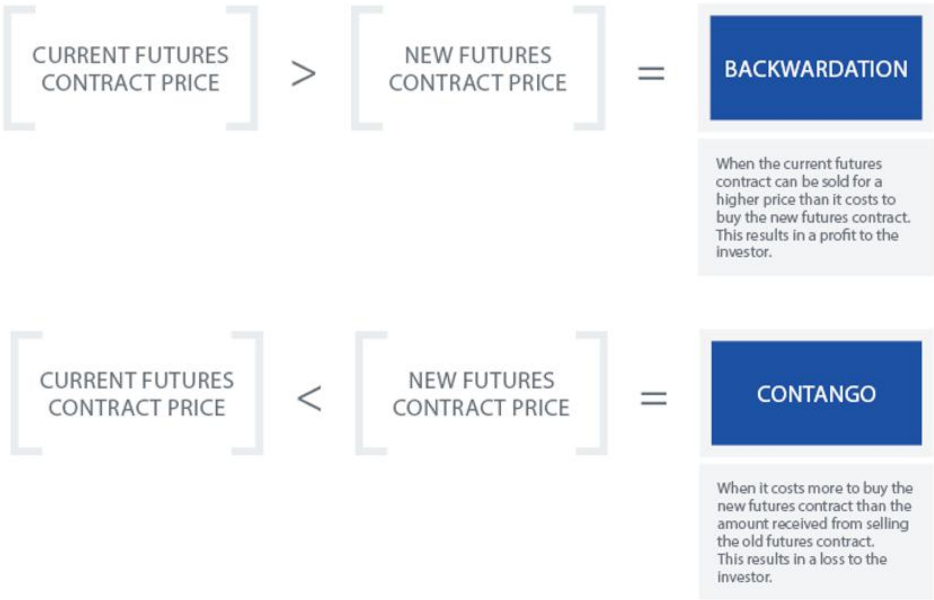
There are Exchange Traded Products (ETP) commodity strategies following futures contracts with a wide variety of length. For example, in Brent or WTI oil ETPs you can find 1-month, 2-month, 1-year, 2-year and 3-year strategies. There are also short and leveraged commodity strategies that may enable you to hedge risks and enhance returns in certain market conditions. Using a number of strategies, it is possible to create a diversified portfolio of commodity funds that may help you to reduce the risks involved with contango and backwardation.

However, trying to determine when it is best to be in short-term contracts or when long-term contracts may make the most sense can be quite challenging.

Dynamic strategies

Today, there are broad commodity ETP strategies that manage these risks and opportunities dynamically. These types of strategies aim to not only move from one type of commodity to another, but also are designed to move to contracts with least contango when the market is in contango and most backwardation when the market is in backwardation. The goal is to minimise the risks and maximise the potential opportunities through dynamic management based on numerous quantitative indicators.

Figure 1: Current and new futures in Backwardation and Contango



Source: Illustration by WisdomTree

Commodity ETPs

Commodities are a smart asset class that can provide investors with the potential for diversification, growth and risk reduction. Today, there are a wide variety of ETPs that can make it easier for investors to access commodities and may also make it easier to manage the risks involved with them.

For more information on commodities, ETPs and other topics, please view our online ETPed ia .

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