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Interest sparked in physical commodities

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A looming **crackdown in the commodity futures markets** is arousing investor interest in the real thing.

Facing a limit on holdings in paper futures contracts, bankers say they have received inquiries from pension funds and other big investors about the practicality of warehousing industrial metals or chartering supertankers.

The inquiries raise thorny issues for the US Commodity Futures Trading Commission as it devises constraints on holdings of energy futures after last year's surge in oil prices. Gary Gensler, chairman, has said he wants position limits to be consistently applied across commodity markets.

Critics say investors could respond by bailing out of futures and hoarding actual commodities, an ugly prospect in the event of a global shortage. Neither the CFTC nor the UK Financial Services Authority has jurisdiction over spot commodity markets.

At Morgan Stanley, the investment bank with the biggest physical commodities operation, "most large investors in commodities in general are worried about position limits – whether they'll be able to carry the exposure they need to carry," says Boris Shrayer, global head of commodities marketing. "We've had a lot of discussions with clients about the physical."

ScotiaMocatta, the Canadian bank, is seeking regulatory approval for a fund that will invest in copper inventories. Credit Suisse is working with Glencore, the world's largest trading house, on an exchange-backed fund backed by aluminium supplies.

ETF Securities, a $15bn manager that offers commodity investment products open to small investors, has launched US gold and silver exchange-traded funds backed by metals in vaults, not futures.

The company is considering a US oil fund tied to swap contracts with a major oil company, which as a commercial participant may be exempt from new CFTC limits. ETF Securities has a similar arrangement with Royal Dutch Shell in the UK, says William Rhind, director of sales and marketing.

John Redpath, global head of oil and agriculture trading at Deutsche Bank in New York, says the bank's recent alliance with physical sugar trader Czarnikow had come at the right time "because changes in the regulatory landscape" are triggering "more interest from investors in physical commodities".

Large investors see commodities as protection against inflation or currency depreciation. They usually buy futures contracts or swaps tracking major price indexes, never taking delivery of raw materials.

Calpers, the largest US public pension fund, recently added $100m in index positions to its commodities portfolio, which was worth $614m in late June. A spokesman says the fund is following the proposed CFTC regulations "with interest" but has not taken a formal position.

Buying physical commodities would be impractical and in some cases impossible.

Industrial metals take up lots of space and are dispersed in warehouses around the world. Oil is volatile and holds big risks, costs and environmental liabilities. Livestock, which makes up 4.3 per cent of the S&P GSCI commodities index, would be a non-starter.

"It is difficult for most pension fund or asset managers in midtown Manhattan to own oil in Cushing," the Oklahoma delivery point for Nymex crude, says Mr Shrayer. As a result, many institutional commodities investors have expressed more interest in trading commodities on non-US exchanges than attempting to own physical commodities.

Bankers have talked about special-purpose vehicles owning commodities on behalf of funds or collecting royalties from production. But investors would have to deal with negative publicity in the event of a supply crunch.

"If institutional investors are forced to gain commodities exposure in the physical market, they will create direct demand and push up prices. Regulation will have caused the very result it is trying to prevent," says Douglas Hepworth, director of research at New York-based Gresham Investment Management, a company whose holdings in corn, soyabeans and wheat futures were recently capped by the CFTC.

Big investors are more likely to try to buy futures on foreign futures exchanges in London, Dubai or Shanghai, bankers say. The GSCI's manager, Standard & Poor's,is exploring a new commodities index based on futures contracts listed outside the US.

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