Chapter Two

Passive Investment Strategies in Commodity Markets

This chapter is devoted to passive investments in commodity markets with a portfolio of futures contracts. The aim of this chapter is to provide a detailed discussion of how investments in futures contracts in the commodity markets operate, with particular emphasis on the existing sources of profit and the methods of their exploitation by the investor, using different baskets of futures that comprise the commodity indices. A thorough understanding of sources of profit in the commodity markets of futures is necessary for further analysis of the potential impact of the financialization of the commodity markets on the validity of investing capital in these markets.

The chapter consists of several sections. We start with the brief history of commodity markets before we go on to discuss the various sources of profit that determine rates of return in the commodity markets. The theoretical justification for the existence of long-term positive returns in commodity futures markets and the explanation of the formation of futures curves are the subject of the next section of the material. Then we review and discuss the rules of establishing commodity market benchmarks, with the intention of selecting a benchmark best representing this asset class—from the investor’s point of view. The chapter ends with a critical review of the existing literature on the validity of investing capital in the commodity markets.

The Genesis of Investments in the Futures Market

Although futures contracts are now associated mainly with electronic trading and advanced technology, nonetheless, in spite of appearances, they are not a novelty in the financial market. There is no consensus in existing literature on the beginning of the futures market; some authors date it back to antiquity. One of the first transactions that bears the hallmarks of a futures contract can be found in Politics by Aristotle. The author tells the story of Thales, a poor philosopher from Miletus, who used his skills to forecast an abundance of olives in the coming fall. Being sure of his own predictions, Thales entered into contracts with local producers of olives. He prepaid an appropriate collateral and acquired the right to the exclusive use of olive
presses during the harvest season. Thales successfully negotiated low fees because, at the moment of conclusion of the contract, nobody knew whether the harvest would be successful or not, and the producers wanted to protect themselves against the risk of bad crops. When in the autumn, a time of harvest that proved to be extremely abundant had come about, and the demand for the use of olive presses heavily outstripped the supply, Thales sold his rights at much higher prices. Thanks to the accurate forecast and skillful transactions, the poor philosopher earned a lot of money.

The origins of the futures markets are also dated to the age of Tulip mania in the Netherlands (Dash 2001); nonetheless, the first organized futures market was most probably born in Japan. We mean here the Dojima rice exchange (jap. Dōjima kome kaisho), on which the trading with futures contracts has been carried out since 1710 (West 2000).

Despite the Asian and European roots that have already been listed, the origins of the futures in their current form should be seen in the grain markets of the United States, especially in Chicago—the most important point on the map of history of the futures markets. In the early nineteenth century, the vast majority of American farmers produced grain mainly for their own use, to feed their families. However, by as early as the 1850s, the development of large area production led to the growth of trade, infrastructure, warehouses, and railways, and to the increased scale of activity of the merchants. As a result, new forms of financing were looked into, which, after a transitional period of bankers’ acceptances (Santos 2008), led to the birth of the forward contract (not the futures).\(^1\) The literature indicates that the first futures contract in the United States was concluded on March 13, 1851. Soon after that, a grain categorization, standardization, inspection, and storage system was established. These factors were positively influencing the development of the commodity markets (Chandler 1977, p. 211). One of the largest and the most prominent was to be the Chicago Board of Trade, established in 1848 (Lurie 1979, p. 27).

An important date in the development of futures markets is March 27, 1863. That was the day when the Chicago Board of Trade (CBOT) adopted the first rules and procedures for the settlement of futures contracts (Hieronymus 1977, p. 76). It was an extremely important issue to the operation of the market, because it was usually easy to find a trader prone to take a position in a futures contract, but it was very difficult to find an investor willing to participate in the final settlement of the transaction. It is worth mentioning that back then, the contracts were usually settled with a delivery not with money (Santos 2008).\(^2\)

May 1865 is considered the beginning of the organized futures market, but it is difficult to pinpoint the exact date. It was a period during which the CBOT standardized contracts specifications, defined collateral requirements, set out the procedures related to settlement and supply of contracts, and restricted trade in contracts to the exchange members (Hieronymus 1977, p. 76). In other words, in May 1865, the forward contracts were transformed into the futures contracts (Santos 2008).