DERIVATIVES

# Rush for resources

Commodity-linked structured products are expected to experience a rebirth this year, with some banks already reporting a trebling of monthly volumes compared with only a few months ago.

Institutional and retail investors have led the surge, buoyed by a rally in underlying commodities including crude oil and gold (see graph). Falling implied volatility has also boosted interest from other players keen to boost returns through more complex structures.

"Since last August we've seen demand for commodity-linked structured products come back, driven in part by the equity rally story," said Yvonne Handler, executive director of commodities at Morgan Stanley in London. "We have also seen interest from hedge funds looking to get into complex structures to lower the cost of their trades."

Underlyings such as oil, wheat and coal all expected to rally because of growing demand from emerging countries and supply pressures. Unfamiliar with forward curves and option pricing, many investors are turning to structured products and exchange-traded funds as alternative ways to monetise their views.

One simple strategy involves obtaining leveraged exposure to a basket of commodities through call spreads, while another area being pushed includes auto-exchangeable products that vary pay-off depending on the performance of the underlying assets. Shipping arbitrage, playing gold against oil and straight plays are also being pushed.

"Investors are certainly moving to next generation beta strategies," said Ken Merideth, co-head of global commodity index and products at Bank of America Merrill Lynch in Houston. "It's no longer about going long in the front month. And demand is growing, driven in part by the inflation story."

Dealers say that a desire to hedge inflation is driving a large part of the demand. Many studies have shown the marked correlation between the asset class and consumer prices, and with the cost of inflation hedging increasing, pension funds and other investors are looking for alternative ways to guard against price rises.

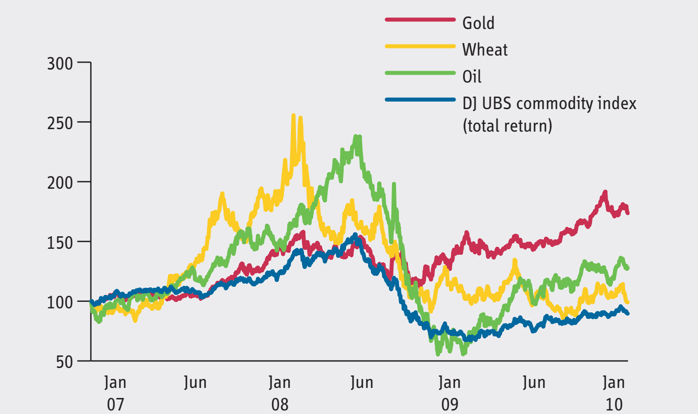
"There's a different risk-reward characteristic to using commodities to hedge inflation rather than hedging it through the bond market," said Merideth.

Banks are increasingly turning to corporate clients, too, as potential customers for their commodity-linked structured product offering. Producers in regions such as Latin America have been keen of late to invest, driven in part by their bullish views and knowledge of the asset class.

"This growth will continue," said Handler. "Alongside our traditional investor base, we're also now targeting companies to increase their use of structured products, overlaying their hedging processes, as a way to supplement their view on how commodity markets might pan out on a macro level."

"We're in the early stages of investors allocating their weightings towards commodities," said Trent Stout, co-head of global commodity index and products at Bank of America Merrill Lynch in London. "People are taking a measured approach to it."

**Commodities performance (rebased)**




Source: Thomson Reuters