RAND MERCHANT BANK
A division of FirstRand Bank Limited
Traditional values. Innovative ideas.

RMB Global Markets: Quanto Futures

The case for investing in commodities

Investing in commodity markets has increased sharply over the last few years. We are introducing a quanto commodity future to the South African market via listing on SAFEX. The initial commodities that the quanto futures will reference are Brent crude oil, gold and copper.

Commodities have shown large returns over the last decade (see Table 1). The rationale behind putting your money in a commodity is to capture the price movement of that particular raw material, which is driven by underlying supply and demand fundamentals. These are varied and encompass economic, geo-political, social, political and industrial factors.

This wide array of possible drivers makes commodities an ideal investment asset to capture interrelated global themes. The use of commodities as inputs into everyday life (see Fact box) also make investment products suitable for use in hedging and risk management.

Table 1: Commodity returns over the period 2000 – present

Gold	Copper	Oil
15%	12%	12%

Source: RMB Global Markets
Data as at July 2012

Table 2: Historic correlation estimates

	Gold	Copper	Oil
Correlation with USD/ZAR	-40%	-55%	-50%

Source: RMB Global Markets
Data as at July 2012

The complexity facing an investor is that the effect of the USD/ZAR exchange rate often dampens or amplifies commodity price movements. The rand is one of the most volatile currencies in the world, which makes it difficult for investors to truly capture the price effects of supply and demand factors in the commodity markets. In a number of cases, the appreciation of dollar-denominated commodities prices is offset by a strengthening of the USD/ZAR exchange rate.

Fact box: Applications of metals

Copper

- Electrical (power cables)
- Electronics and communication (wires)
- Construction (plumbing)
- Transportation (radiators)

Gold

- Jewellery
- Technology (dentistry)
- Transportation (industrial catalyst))

Oil

- Transportation (car and air travel)
- Electricity generation
- Residential
- Industrial (feedstock)

The South African case for quanto investment products

Through interaction with our clients, we have ascertained that the "currency effect" is a major factor in considering whether or not to invest in commodities. (This is also known as asset contamination.) There is thus a market need for a rand-denominated investment product that delivers the same pay off as a pure dollar-denominated commodity investment.

The provision of investments in foreign assets are tightly governed by South African exchange control regulations. Commodities, as dollar-denominated assets, are regarded as foreign assets. Indeed, the major underlying commodity futures are listed on foreign exchanges and denominated in foreign currency. Thus, investment in commodities is subject to certain exchange control regulations. The one characteristic that exchange controls impose on commodity investments of various forms is that they must be listed and settled in rand.

To this end, we are introducing a quanto commodity future to the South African market. Investors will typically use a quanto product when they feel that the price of an asset will appreciate, but that the currency in which the asset is denominated will depreciate relative to the investor's domestic currency.

Merits of the product

Quanto futures will be a rand-denominated commodity investment product that delivers the same payoff as a pure dollar-denominated commodity investment. Therefore, investors will be immune to the effect of USD/ZAR exchange rate fluctuations, allowing them to invest and derive a payoff, purely from the dollar price performance of the underlying commodity.

Numerical example

A quanto product can simply be understood as follows: if the price of a commodity, say Brent crude, increases by 20% in dollar terms, then the value of the investor's rand position in Brent crude (via the quanto product) will also increase by 20%. The movement of the rand relative to the dollar plays no part in determining the investor's return.

Figure 1: ZAR gold price vs. USD gold price

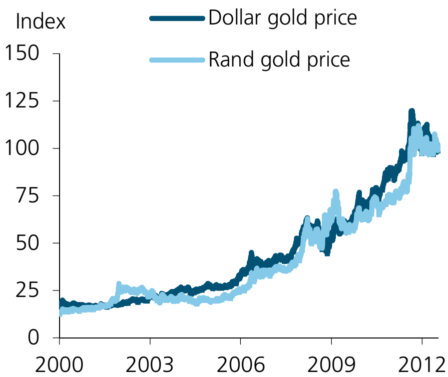


Figure 2: ZAR copper price vs. USD copper price

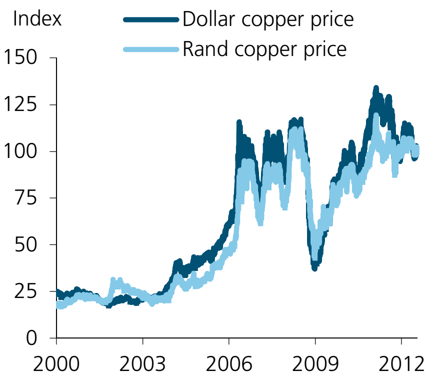
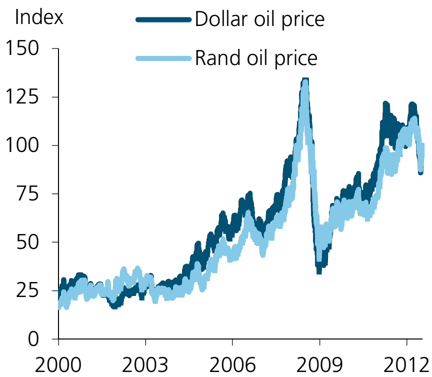


Figure 3: ZAR oil price vs. USD oil price



Note:
Data as at and indexed to July 2012.
Source: Bloomberg, RMB Global Markets

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