

Investing in soft commodities: Be wise!

How do financial investors influence food commodity prices? How are investors impacting the value chain of soft commodities as well as productive investments in the food sector? Sustainable Finance Geneva (SFG) organized a lively conference and discussion in order to increase awareness of responsible investing solutions in this sector.

A striking increase in the involvement and influence of financial investors in commodity markets: the big picture.

David Bicchetti - economist with UNCTAD- first painted the big picture showing the remarkable financialization of commodity markets during the last ten years as well as the very clear increase of cross-market correlations. He finally pointed out how crucial the expectations of financial investors have become and how they increase commodity price volatility.

In 1998, 77% of transactions were due to the physical demand for commodities, while this number fell to 31% in 2008. While financial transactions dominate at present, fundamentals such as the increase of demand from China play a continuing important role. The increase in speculative demand has however matched this rise. According to certain models, prices of several commodities such as petrol, wheat and maize rose 20% above those justified by fundamentals during the 2007 to 2008 period. Speculative investors are also moving towards more sophisticated products with a growing hedge fund activity. This has led to an increase in price volatility and correlations between commodities and the main stock markets and exchange rates.

One result is that investing in commodities no longer serves diversification or risk mitigation strategies. Another is that extreme price variations give false signals to the real economy freezing or distorting investment decisions. In this context, UNCTAD recommends increasing transparency in physical, futures and OTC commodity markets, tighter regulation of financial investors and price stabilization schemes.

Response: essential and responsible financial markets?

Asked to react, each speaker pointed to what struck them during this presentation. For **Nabil Marc Abdul-Massih**, Portfolio manager at INOKS Capital, a company that takes pride in not speculating, it is this new importance of purely financial players in commodity markets. Their herd behaviour leads to a self-nourishing cycle of emotional investing completely disconnected from fundamentals. He however notes that the provision of liquidity to markets once burdened by physical exchange monopolies is welcome. He warns against the excessive leeway to invest in this sector.

For **Jeremy Baker**, Commodities Analyst at Vontobel Group, markets provide incentives for the new supply of capital. And the food sector is in great need of capital. He believes that fundamentals are large drivers of price movements and that China's role is underestimated in Mr. Bicchetti's presentation, as well as that of the weather.

Chris Walker, Manager Innovative Finance – GAIN (Global Alliance for Improved Nutrition), stresses that excessive volatility in food commodity prices harms consumers on the margin and that the role of financial market is to supply capital to companies whose objective is to give access to nutritious and affordable food.

What are the solutions for responsible investing in this sector? Are responsibility and profit compatible? Yes, and the priority is to finance real-economy investments with careful attention to the most vulnerable producers and consumers.

According to **Nabil Marc Abdul-Massih** the key is to provide capital for the production or transformation of food in partnership with those providing land and work. This requires a lot of analysis and knowledge of the sector and enables the creation of profitable enterprise all along the value chain. The fair participation of workers as well as the production of food

for local markets are key elements. What matters is who is getting what and how much of the price is going to the producer downstream. A rise in prices and volatility does not provide an incentive to the producers when it does not go to them. There are other ways of incentivising supply. Regulating the market is necessary in present circumstances.

Jeremy Baker makes the point that the word “sustainability” while a good concept is often an abused word. If food is to be sustainably produced, consumers in developed countries are going to have to pay a higher price for it. He brings to attention the crucial role the large food industry plays in dealing with workers, including children, in the sector. According to him, consumers should be the ones to pressure companies. Insisting on the great need for capital investment and being reluctant to the idea of regulation in the sector, he however recognises the necessity to adapt certain rules that enable morally debatable behaviour. For example, he agrees with Mr Bicchetti that physically-backed commodity ETFs should be banned.

Chris Walker would like to see financial markets resume their role in smoothing volatility and providing capital at reasonable cost to smaller local producing companies.

There is a forgotten element in this debate according to **Nabil Marc Abdul-Massih** which is the vast amount of capital necessary to improve the presently inefficient logistics of moving soft commodities from one point to another. Opportunities to invest, and in a responsible manner, are huge in this segment. There is going to be a drastic change in the way food will be provided as Brazil cannot continue to feed China. Food production will have to be developed in China itself.

The audience reacts to « land grabbing ».

After highlighting the complexity of commodity markets and mentioning that fresh water has been left out of the commodity discussion, the audience turned to questioning land investments in foreign countries known as “land grabbing”. The speakers agree that the rule is very simple: responsible investing must increase food production while using local production factors, i.e. work and land, and part of the food production must serve local consumers. Then this type of investment would not be “land grabbing”. Pension funds should abstain from investments that do not go by these rules and prefer investments in their own geographical area as an excess supply of non-productive capital has a negative influence on commodity prices. All agree that it is necessary to increase transparency in both physical and financial commodity markets. The creation by GAIN of the Access to Nutrition Index (ATNI) which will rank companies according to what they are doing to provide nutritious and affordable food is a step in the right direction.

Conclusion: financing productive investments with local partners

- There is a remarkable increase in financial participation in commodity markets as well as a very clear increase of cross-market correlations with main stock markets and exchange rates. Financial investors’ expectations are crucial and increase price volatility. As a result, investing in commodities no longer serves diversification or risk mitigation strategies and extreme price variations send false signals to the real economy.
- There is a huge need for capital to finance production, transformation and efficient logistics in the food sector. This demand will continue to increase with drastic changes in the way food is grown and provided to the consumer on the horizon.
- Finance should concentrate on investing in productive enterprises aiming at producing and transporting nutritious and affordable food, including for consumers in producing countries. Appropriate financial products can diminish price volatility.
- Responsible investment establishes a partnership between financial capital owners and those holding the other forms of capital, i.e. work and land. Careful attention should be paid to the circumstances of small producers downstream and of local consumers.
- Responsibility must include the food industry and consumers from developed countries should be ready to pay their food at a higher price if they believe workers, including children, and the environment are to be paid more respect.
- Increased regulation and control are on the horizon, in the meantime there is a need for self-limitation in this critical area.