To: Commodity Futures Trading Commission
Washington, DC

The Agricultural Market Roundtable, sponsored by the CFTC on April 22, 2008, was highly informative with respect to building cross-industry knowledge of the working of the markets and included discussions on how commodity index investors are viewed by other market participants. I enjoyed the opportunity to participate in person, and am pleased to offer follow up thoughts.

Futures Market Objectives

Index investors, many of whom are also consumers of commodities, support any activity that improves the efficiency of the markets that produce what they consume. Index investors know that commodity futures markets meet another objective – they allow investors to reduce the risk of their portfolio while also protecting it from inflation. They perform this activity while at the same time assuming price risk that commodity producers and holders of commodity inventories wish to mitigate. In a properly functioning market both parties benefit over time.

What is a Commodity Index Investor?

Diversified commodity indexes represent the return that an investor would achieve by holding and rolling forward a broad range of commodity futures contracts on a fully collateralized basis, and without taking a position on whether individual commodity prices would go up or down. "Fully collateralized" typically means that, for every dollar of notional exposure to a commodity futures contract, the investor holds a dollar of collateral backing, with no borrowing or leverage. The mechanics of rolling forward their positions means that, not only will index investors never take delivery on a contract, but they will not maintain positions in the delivery month. The index investor may implement his exposure directly in the futures markets, or by engaging in over–the–counter swaps on commodity indexes.

The index investor must not be confused with discretionary commodity pools or hedge funds, who may move in and out of individual markets based on their expectation of rising or falling prices, and who might rapidly change their views. The index investor holds consistent long positions, and therefore consistently assumes price risk which producers and inventory holders wish to mitigate. And once an index investor establishes his initial position, his market activity typically is simply that of "rolling" his positions. That is, he simultaneously sells a nearby contract and buys a more distant contract, so that there is no net buying pressure across the overall futures curve.

Concerns Expressed at the CFTC Roundtable

Participants expressed concern over the following issues:

- Sometimes in some markets there has been a lack of convergence between cash and futures price, with futures <u>in the delivery month</u> trading <u>higher</u> than cash prices. This creates a burden on hedgers of inventory who are expecting that convergence.
- Futures prices have become more volatile.
- Commodity futures prices have risen dramatically, causing margin financing difficulty for market participants who hedged inventory or production by selling short at lower prices.

I would like offer my view of whether commodity index investors were a factor in these issues.

<u>Convergence</u>

At the Roundtable we saw quantitative evidence that, sometimes in some grain markets, there was a lack of convergence of futures to cash in the delivery month. Solutions discussed included a change in delivery specifications, revised storage charges, more delivery points, and even a move to a cash-settled contract. In cotton, the evidence was more anecdotal but nevertheless compelling, that futures have traded above cash after the first delivery day. There were even suggestions that, specific to cotton, the CFTC should investigate recent market behavior. For instance, a participant in the cash cotton market stated, outside the formal Roundtable, that he could not tender cotton for delivery since all delivery warehouses were full.

Commodity index investors, like all commodity investors, support efforts for futures prices generally to converge to cash prices, with a basis that varies as little as necessary. This is a critical part of the economic rationale that supports their return expectations, and it also is essential for efficient (and therefore low cost) operation of commodity producers, whose products the index investors, since they are also consumers, purchase. Therefore any moves to improve convergence are supported. But participants should recognize that the commodity index investor is not a participant in either the cash market or the delivery month, which are the two prices that are expected to converge. Even more to the point, the commodity index investor, by rolling his position prior to the first delivery day, may exert some <u>downward</u> pressure on the nearby (non-spot) contract. So the index investor is not contributing to lack of convergence, when futures trade higher than cash in the delivery month. And the commodity index investor certainly owns none of the cotton inventory that was reportedly filling delivery warehouses earlier this year.

<u>Volatility</u>

Volatility in futures prices can be caused by large and sudden flows of buying/selling pressure, which in turn might be driven by A) a change in expectation of what the future price will be, or B) a change in the desire to be invested in a particular commodity. The index investor, by definition, is not influenced by A), since they do not change positions in individual commodity markets based on price predictions.

Regarding B), index investment has slowly increased over the last five years, but as a percent of daily volume or open interest, the new investment over a day or a month is small relative to the overall liquidity of the futures markets.

Hedge funds and commodity pools, on the other hand, might at times contribute to more futures volatility. Commodity pools, if they follow trends, can swing from long to short and back to long positions. Hedge funds might also, based on fundamental or technical or quantitative analysis (or liquidity requirements elsewhere in their portfolios) move rapidly and in large size in and out of individual markets. But these flows don't necessarily occur on a daily basis nor in the longterm do they have meaningful impact on price levels of the physical commodities in the cash markets. On the other hand, low inventories in a commodity, which is a condition that can persist day after day, can in and of itself, be a source of increased volatility, as a small change in fundamental factors can create a large change in expected price due to the low price elasticity of physical products.

Index investors, with their stable long positions, could provide liquidity to any sale program and could actually be an offset to volatility caused by other factors.

Rising Commodity Prices

Commodity index investors, in their role of investor and not as individual consumer, do not own, store, or consume a single bushel or ton of any agricultural commodity. While their participation in the markets may aid price discovery, which is an objective of those markets, any impact in terms of higher cash prices is both immeasurable and not nearly as important as supply, demand, and inventories in the physical markets. For instance, rice, which is not part of the portfolios of index investors, has seen price rises comparable to that of wheat and corn.

In the CFTC roundtable, some market participants who had hedged by shorting futures at low prices, described how they were adversely affected by the cost or availability of margin financing as prices rose. If a producer, or holder of inventory, had adequate margin financing, they might withstand the strong rise in prices we have seen (though perhaps regretting that they established their hedge so soon). The scarcity of margin financing is not due to the market activity of index investors. It is due to the broader lack of liquidity in U.S. credit markets.

Some Final Thoughts

Commodity market participants are witnessing a current environment of increased price volatility, occasional lack of futures/cash convergence, and lack of margin financing. Index investors understand those stresses and hope they can be relieved through contract modifications and eventual increased liquidity in the U.S. financial system, as this would contribute to more efficient operation of the U.S. agricultural economy. Index investors hope that the increase in prices compared to the unsustainably low levels early in this decade will signal the need for increased production to meet

global demands to build inventories and thus reduce price volatility. In the meantime index investors, subject to existing regulations, will continue to provide risk mitigation to commodity producers and inventory holders, while also providing inflation hedging and risk diversification to individual investors, retirement plans, endowments, and foundations. Under existing regulations, this is a win-win situation.

The view expressed herein are my opinion and may or may not be the views of my employer.

Bob Greer
Executive Vice President
PIMCO