Testimony of

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Thank you, Mr. Chairman and members of the Committee. My background with commodities and derivatives goes back 22 years. However, I do not believe that my firm or I would benefit or be harmed by the policy changes being considered. I am here because, when I first began examining this issue six months ago, I came to the conclusion that this was public policy concern.

The largest drivers of recent commodity price inflation are almost certainly demand growth from developing economies and weakness in the dollar. In the long run, too, markets find their price level based on commercial production, usage, and inventory changes. In short to intermediate periods, however, speculators can be disruptive, influencing prices and hurting consumers. Pension and index investment has become a third force in stoking commodity inflation and damaging the structural integrity of the futures markets. Their activities can fairly be said to represent "excessive speculation."

These new participants -- and I'll follow the lead of others -- are commonly called "index speculators." When I use this term, and terms like "excessive speculation, " it's in a neutral, technical sense; I don't intend these to be judgmental labels. These index speculators represent managers of pensions, endowments, and other investment pools that aren't normally associated with speculation. These money managers are seeking portfolio efficiency by blending non-correlated, productive assets. The dot-com bust and the parallel interest in alternative investments led many of them to consider commodities as a portfolio addition. Regardless of the merits of this approach, there's an overriding practical concern -- the commodity markets and the futures exchanges were meant to serve the needs of commodity producers and users, not investors. This marketplace is ill suited for index speculation.

All this must be understood in the context of how *index* speculators differ from traditional ones. They are overwhelmingly oriented to the long side of the market, commonly do not deploy leverage, and hold positions for long periods of time. They add substantial interest to the long side of the market without actually creating much trading volume. In essence, they actually reduce market liquidity.

Part of the problem is relative market size. Index speculators are draining funds from an ocean of traditional investment assets, represented by thousands of stock and bond issuers, into what are effectively small ponds: two dozen futures markets. It's important to note that this the impact will only grow; many institutions have been only "testing the waters" and are increasing their allocations to this strategy. Institutions that have not yet participated will increasingly follow the lead of others who have. The $260 billion currently allocated by index speculators is only the beginning of a trend. We can reasonably expect the holdings of index speculators to increase more than 10-fold, and perhaps as much as 15-fold[1]. From a policy perspective, we must assess not only the current impact, but the future as well.

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[1] University endowments have led the embrace of alternative investments, with other investors following. According to the latest survey of the National Association of College and University Business Officers, large endowments already allocate 3.6% of assets to "Natural Resources." Using this as a proxy for index speculation, and in light of the approximately $100 trillion global pool of publicly traded stocks and bonds, a potential global allocation of $3.6 trillion can be estimated. A report by the British regulator, FSA, (Growth in Commodity Investment, 3/26/07) infers that a higher percentage may be possible.

There are those who claim that index speculators have no real impact on futures prices, since for every buyer there must be a seller. This misses the point, which is, what determines the price at which those two participants meet? Is there any market in the world where the net addition of $260 billion on the long side of the market wouldn't move prices higher? Maybe a lot higher, maybe just a little, but higher nonetheless.

Some concede that futures prices may be impacted by index speculators, but claim this has no bearing on the cash market. The mechanisms by which futures prices influence physical prices vary both by commodity and environment. In some cases, there is a clean arbitrage transaction, so that a rise in the futures will directly translate into higher physical prices. Sometimes, futures impact cash less directly by providing a reference or index price on which physical transactions are based.

There may be some instances where index speculation indeed influences futures prices disproportionately more than cash prices. However, this is harmful in another way. Commercial users of the futures markets need to rely on predictable relationships between cash and futures. When these relationships break down, commercial participants either flee the market or are forced to bear or pass along additional costs.

In all these considerations, one can argue in good faith whether index speculators create a large or a small impact. Those who believe that there is only a minimal influence should consider a future when these index speculators will command far greater assets.

There are numerous proposals before Congress to address these concerns. In my opinion, imposing speculative position limits on both futures and swap desk transactions appears to be the best solution[2]. This would require more transparency in swap markets than we currently have. It may be that position limits alone are insufficient to curb the distorting influence of index speculators, and some sort of aggregate limitation should be imposed. I do not think this view is currently supported by the evidence, and position limits are an appropriate and productive first step.

This would, of course, restrict the use of index speculation as a portfolio strategy. Portfolio managers do have alternative tools for inflation protection and exposure to commodity pricing – not identical to be sure, but reasonable nonetheless[3]. Each marketplace has its own rules. Traditional equity and bond managers should be expected to play by the rules of the commodity market when they trade futures, and those rules should, and traditionally have, included speculative position limits.

*** End of Testimony ***

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[2] Raising speculative margin requirements appears to be a particularly risky policy. For a more thorough review of this, please see the Appendix, which includes my article, "Margin Madness," published on MarketWatch on June 10, 2008.

[3] TIPS are a well recognized portfolio tool for providing inflation protection. Preliminary research suggests that an equity index like the Morgan Stanley Commodity Related Equity Index offers a strong alternative to index speculation, offering high correlation with commodity rallies, and lower correlation in declines.

APPENDIX

As published on MarketWatch on June 10, 2008

Margin madness

Commentary: Proposed regulatory cure will only worsen the crisis

By Jeffrey D. Korzenik
Last update: 6:18 a.m. EDT June 10, 2008

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BOSTON (MarketWatch) -- Last Friday's startling spike in oil prices has refocused attention on the role of futures speculators in driving inflation. Higher energy prices are likely to renew calls to raise margin requirements for speculators in an effort to moderate prices.

Those calling for this approach have misdiagnosed the problem and prescribed the wrong cure. Higher speculative margin requirements could well result in higher prices and the further decay of the structural integrity of the futures markets.

Unfortunately for consumers and for concerned policy makers, there's no "quick fix" that strengthens the dollar or increases oil production to meet demand from the developing world. Policymakers instead are focusing on the role of non-commercial participants in the commodity futures markets. Much has been made of the supposed role played by "speculators," but this term no longer adequately describes the full breadth of non-commercial participation in today's market.

There are indeed still speculators of the traditional variety -- highly leveraged players who play both the long and short side of the market and move quickly in and out of positions. However, today's commodity futures activity is marked by the presence of a new type of non-commercial participant. These new players treat commodity futures as an investment asset class, and they represent some of the largest pension funds and asset managers in the country.

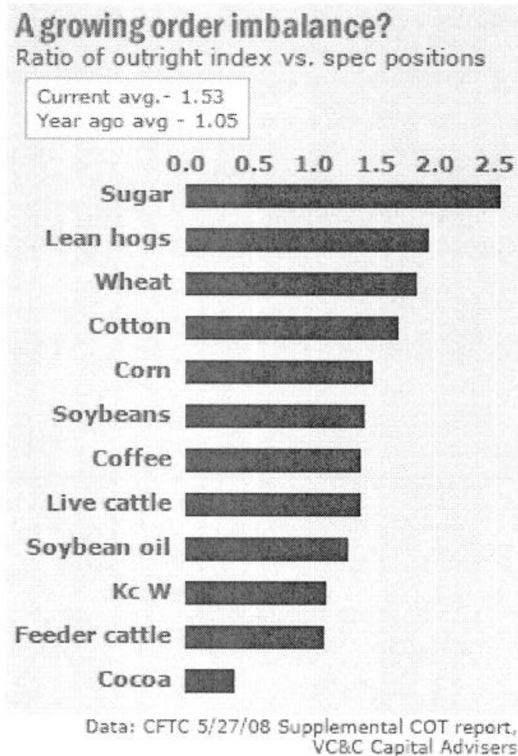
These "commodity investors" behave very differently from the speculators. They are overwhelmingly oriented to the long-side of the market, commonly do not deploy leverage, and hold positions for long periods of time. Policy makers seeking to moderate commodity prices need to distinguish between speculators and these new commodity investors.

There has been a recent debate about the impact of these commodity investors. There is a strong argument to be made that these new investors both push commodity prices higher and disrupt the market. Unfortunately, some of the debate has been informed more by sentiment than by fact -- after all, we instinctively think of "investment" as good and "speculation" as bad. In the futures world, the

opposite is true. Speculators, with their high levels of margin and short-term trading, create a tremendous amount of volume with a limited amount of capital, ensuring critical market liquidity. Investors, on the other hand, provide little benefit to the futures world, and lots of problems.

The commodity markets operated quite efficiently without "investors," who have only entered the arena in any size within the last few years. The introduction of roughly $260 billion dollars of long-only investment has effectively created an order imbalance -- futures prices have had to move higher to draw out opposing short interest. The capital pools upon which the investors draw upon are quite deep. In contrast, traditional speculators have limited trading capital. Commercial participants are constrained by both the size of their working business capital and by the amount of physical commodity they can control. The capital committed to commodity investors is large and growing, and if current trends continue unchecked, it could grow to several trillion dollars.

Much has been made of the investors' position size relative to the physical marketplace, but it is also worth considering the size of the investor commitments relative to the speculator commitments. The chart below illustrates data from the CFTC's supplemental Commitment of Traders report which includes indexed investor positions for select marketplaces.



Data: CFTC 5/27/08 Supplemental COT report, VC&C Capital Advisers

The graph compares outright market positions (i.e., spread trades are excluded) of the speculators, both long and short, to those of the investors, and displays the ratio between the two. While an inexact measure, this ratio suggests the relative "firepower" of the investors versus the speculators.

On average, the investor positions outnumber the speculator positions by 1.53:1. When one considers that the investors are virtually only found on the long side of the market, it is clear that this is not a match of equals, hence the order imbalance which puts upward pressure on prices. Moreover, the ratio is trending higher, having been as low as 1.05:1 just a year ago -- if this is indeed an order imbalance problem, it is getting worse.

How does demand for futures contracts impact prices in the physical markets? Because the index investors do not take physical delivery of the commodities, many have been too quick to dismiss their profound impact. While it is true that over the very long term, physical supply and demand will

determine the outcome, futures investors are an inflationary force in shorter time frames. This is particularly true of markets like energy, where neither supply nor demand is very responsive in the short term to higher prices.

There are three mechanisms by which the order imbalance created by commodity futures investors can drive prices higher in the physical market:

1. Higher futures prices directly impact those who contract to buy or sell on a forward basis (e.g., airlines which contract for future fuel needs, either directly through futures hedging or through physical sellers who price on the basis of the futures market).

2. When futures prices are bid up independent of the physical market, this stimulates an arbitrage trade, where cash goods are purchased and futures are sold, locking in price differentials but driving up cash prices

3. The imbalance within the futures markets disrupts traditional cash/futures relationships which ultimately adds risk, uncertainty and cost along the commodity supply chain. This is ultimately reflected in higher prices to the consumer.

In addition to these direct influences, there is also a case to be made that the higher futures prices support an inflationary psychology. We all face the bombardment of news of higher prices in energy, food and precious metals. It may be that this increases the willingness of commodity users to pay higher prices, and of commodity users to demand increases as well.

What would happen if the regulators chose to raise speculative margin requirements? How would this impact the order imbalance caused by the investors' capital? The answer is unequivocal -- higher speculative margin would increase rather than decrease commodity prices. Higher margin would decrease the ability of traditional two-sided speculators to establish positions, and would not impact the long-only, unleveraged commodity investors. This would increase the ratio of commodity investors to traditional speculators. To the degree this order imbalance is causing higher commodity prices, it would only get worse.

Policymakers would be well advised to consider other tools at their disposal. At the end of the day, commodity investors are using the futures markets in a way that they have never been used before -- and for which they are ill-suited. It is a legitimate question of public policy whether this should be constrained or even permitted. The investment community, too, should reconsider the legitimacy of consumable goods as a core asset class. After all, the last time we considered an agricultural good a great investment, the commodity was tulips.

Biography

Jeffrey Dean Korzenik

Jeff is the chief investment officer of Vitale, Caturano & Company, Ltd., a diversified wealth management, business consulting, and public accounting firm with 30 partners and 350 employees, located in Boston. Jeff leverages his 22 years of Wall Street experience to provide Vitale, Caturano clients with market insight and investment research through the firm's registered investment advisory, VC&C Capital Advisers.

Jeff began his career in 1986 with E.F. Hutton & Co. (a predecessor firm of Smith Barney) in New York. His background includes serving as a senior analyst in the Smith Barney equity research division and as the currency and interest rate futures analyst for PaineWebber, Inc. A recognized thought leader, Jeff has helped develop new securities including various first-in-industry investment vehicles. During his 15 years at Smith Barney, he held various executive level positions in New York and Chicago before moving to Massachusetts in 2001. In 2005, he became president of Salem Five Investment Services, the wealth management subsidiary of a 150-year old New England bank, before joining Vitale, Caturano in 2008.

Over the years, Jeff's work has been cited in publications and websites including *The Wall Street Journal, MarketWatch, Reuters* and Germany's *Die Zeit.* His research has been reprinted in books, newsletters, and magazines within the industry. He speaks on a broad range of topics including derivatives, asset allocation, trends in fiduciary oversight, and philanthropic planning.

Educational Background:

Princeton University:

A.B, Economics, 1985

Certificate of Proficiency in Near Eastern Studies, 1985

Memberships and Boards:

Peabody Essex Museum:

Board of Overseers

Chair, Corporate Membership Committee

Commissioner: Essex National Heritage Commission

Salem State College Foundation Board

Symphony by the Sea Advisory Board and Past Treasurer (2002-2004)

Girard School of Business at Merrimack College Advisory Board

Salem Theatre Company Advisory Board

Committee on Agriculture
U.S. House of Representatives
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Source: None Amount: ____________

Source: ____________ Amount: ____________

2. If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) the organization has received since October 1, 2004, as well as the source and the amount of each grant or contract:

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