

Investors Benefit from Fair, Liquid Commodities Market, ICI Tells Hill, July 2008

July 15, 2008

The Honorable Nancy Pelosi
Speaker
U.S. House of Representatives
H-232 Capitol Building
Washington DC 20515

RE: Institutional Investors in the Commodity Markets

Dear Madam Speaker:

I am writing in response to recent suggestions that large institutional investors that invest in commodities using derivatives are responsible for recent food and energy price increases. The Institute shares the concern about recent sustained increases in commodity prices and the consequences of such for individual consumers, and for the U.S. economy as a whole. We support Congress in its desire to address any abusive practices that may contribute to this situation. We also support efforts to ensure that U.S. commodity markets remain fair, liquid, and competitive.

We are concerned, however, that initiatives intended to limit the ability of certain investors to invest in commodity-based assets would sharply limit liquidity in the U.S. commodity markets, drive commodity trading to offshore markets that are not accessible to U.S. regulators and are generally less transparent, and ultimately fail to reduce the price of oil or solve the inflationary pressures we confront today. These initiatives could also deprive American investors, including millions of small investors in mutual funds, of investment returns that counterbalance equity market losses and help to preserve purchasing power, family nest eggs, and retirement savings.

Most financial advisers now believe that individuals and institutions should consider allocating a portion of their assets to inflation index assets including diversified commodities. Since the first investable commodity index emerged in the 1970's, investors have recognized the diversification benefits of including commodity investments in stock portfolios. Commodity indexed investments are now important portfolio investments for individual investors as well as retirement plans, college endowments, and foundations. Commodities are generally thought to help investors hedge against inflation, diversify their portfolios, and provide a buffer against downturns in stock and bond prices.

The primary methods of obtaining exposure to commodities include: direct physical investment, a portfolio of commodity stocks, and commodity futures. A direct physical investment in commodities is usually not practical because commodities are often perishable and cannot be stored for long periods of time. A portfolio of commodity-related stocks may not provide the desired market exposure because they represent investments in companies represented in the portfolio rather than the commodities themselves. On the other hand, exposure to commodities using commodity futures through a product designed to track the performance of a commodity index, for example, is thought to provide exposure to commodities in a manner that ameliorates the price fluctuations of the underlying commodities. The over 150 commodity funds open to public investors attest to the attractiveness of commodity index funds for ordinary investors.

Recent financial innovations have made it easier for investors to gain exposure to commodities through investment vehicles that use derivatives to provide exposure to broad-based commodity indexes. For retail investors, one of the most cost-effective and practical means of gaining access to the commodity markets is through passively managed investment vehicles designed to track the performance of a broad commodity index. These investment companies are designed to generate the return that an investor would achieve by holding and rolling forward a large basket of futures contracts on a fully collateralized basis. They operate without leverage; for every dollar of exposure, the investment company holds a dollar of collateral. Commodity index investors assume price

risks that producers and other businesses seek to eliminate. They create both selling and buying demand (i.e., liquidity) in the market by buying long positions, selling futures contracts to offset those long positions prior to the maturity (delivery) month, and establishing new long positions with later delivery months.

Restrictions on who can invest in these funds or restrictions on the funds themselves will only increase the cost of investing in this asset class. Institutional investors, who typically have many more investment options, simply will choose to abandon U.S. funds and markets where these restrictions apply, and invest in commodity funds and markets elsewhere. Moreover, because commodities are traded in global markets and global forces of supply and demand set the prices, efforts to restrict trading in the United States will not create a material change in commodity prices, and may in fact, have the opposite effect.

In sum, the Institute has three significant concerns with placing restrictions on the ability of institutional investors to participate in the U.S. commodity markets. First, most financial planners have long agreed that commodities play an important role as an inflation hedge, not just for institutions, but for individual investors as well. Second, the types of vehicles some proposals appear to be targeting (e.g., commodity based indices) provide efficient and cost-effective means for mainstream investors to get this exposure. Finally, because of the ability of institutions to trade overseas, restrictions ultimately are unlikely to be effective, but will likely increase the costs of trading and lower liquidity in the U.S. commodity markets.

As I noted at the outset, the Institute strongly supports Congress' efforts to ensure the continued integrity and vitality of the U.S. commodity markets. The recent increase in food and energy prices is of great concern to all Americans. Congress should take great care, however, to ensure that the unintended consequences of any proposed market reforms will not outweigh any potential perceived benefits. Thank you for considering our views. Please feel free to contact me directly or Dean Sackett at 202-326-8319 if you have questions about this or any other matter.

With very best regards.

Sincerely,

Paul Schott Stevens
President & CEO
Investment Company Institute