

Talking Points

Focusing the Lens on Brazilian Commodities With the Dow Jones/BM&F Commodity Index



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In an effort to expand transparency and liquidity by measuring local markets, S&P Dow Jones Indices is partnering with B3 (formerly BM&FBOVESPA), the Brazilian exchange, to offer the Dow Jones/BM&F Commodity Index. Given that Brazil is one of the largest producers of certain commodities in agriculture, livestock, and energy, market participants may benefit by having a gauge of price movements locally. Additionally, as financial instruments develop on the underlying benchmark, more liquidity can penetrate futures contracts in Brazil, reducing price volatility and enabling risk transfer from the underlying commodities.

Why did S&P DJI create this index?

Single commodities are generally fungible, meaning interchangeable, and that enables large quantities of a commodity meeting certain standards to be traded globally in futures contracts. However, there are still specific differences in some local commodities that lead to demand for listings in regional exchanges around the world. While select contracts meet the eligibility criteria of flagship indices like the S&P GSCI, Dow Jones Commodity Index, and S&P World Commodity Index, many local contracts are not yet liquid enough to be included in these indices.

The commodity futures contracts listed on B3 do not yet meet the eligibility criteria for inclusion in the major global commodity indices, but they are important locally and globally, since Brazil is a major commodity producer. Therefore, creating the Dow Jones/BM&F Commodity Index using these contracts is critical for measuring prices in the Brazilian market for market participants from the physical and financial industries to facilitate business.

How does the S&P DJI partnership with BM&FBOVESPA enhance the offering?

The partnership between S&P Dow Jones Indices and B3 is important in blending the capabilities of the world's largest provider of financial market indices and the leading exchange in Latin America, which is also one of the largest exchanges in the world.

This is essential for the delivery of indices with top-quality construction and governance that are especially designed for the local market. The partnership allows commodity futures listed on B3 to be included exclusively in the Dow Jones/BM&F Commodity Index as a standard offering, specifically measuring commodity prices in Brazil.

How can this index benefit market participants in Brazil?

The Dow Jones/BM&F Commodity Index will first bring transparency of Brazilian commodity prices to market participants globally. Since Brazil is one of the world's leading commodity producers, understanding local pricing is important for all types of market participants, from producers and processors to commodity industry service providers and funders. Once the benchmark is established, financial products may be designed for better investment access to the underlying index of Brazilian commodities that could provide inflation protection and diversification for capital preservation. Since the base date of the index on Dec. 30, 2010, the Dow Jones/BM&F Commodity Index has shown strong inflation sensitivity, returning 4.6% for every 1% rise in Brazilian CPI, as of April 15, 2017. This means a small investment may provide high inflation protection. Further, the addition of commodities to a traditional Brazilian bond or stock and bond mix may increase the Sharpe ratio significantly by increasing return and reducing risk. For example, a mix of 80% bonds and 20% stocks results in an annualized return of 12.3% and an annualized risk of 8.1%, for a Sharpe ratio of 0.02 during the period studied. However, if the equities are replaced with commodities, the annualized return increases to 16.2%, the annualized risk falls to 6.6%, and the Sharpe ratio increases to 0.62, which is a major improvement. This is not only due to the higher returns and lower risk the local commodities experienced as compared with stocks and bonds, but also the near-zero correlations of local commodities to stocks and bonds.

Lastly, as the most passive Brazilian commodity index, the Dow Jones/BM&F Commodity Index can act as the foundation to build enhanced versions in the future. It can also serve as the composite for indices of single exchange-listed commodities, so that market participants can create their own strategies to generate alpha or manage risk with spreads.

What are the key features that make this index unique?

The Dow Jones/BM&F Commodity Index is the first broad-market commodity index to represent the Brazilian commodities futures market. It includes only commodity futures contracts that are listed on B3 and based on physical commodities. Currently, the index includes 10 commodity futures contracts that are equally weighted by their eight components (coffee and soybeans each have two contracts), with contract weights inside the components determined by liquidity. The weights are rebalanced quarterly, and the contracts held are the next nearby, most liquid contracts that are rolled monthly. The eligibility criteria in the index construction are a unique characteristic set for benchmarking Brazilian commodities, or any group of commodities listed on one exchange and calculated by a major, independent index provider.

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