Commodity Investments in Finland

Helsinki (HedgeNordic) – In an interview with Karri Lehtinen, the Managing Director of Helsinki based MG Commodity Corporation, Mr. Lehtinen gives an overview of commodity investments in Finland, which has emerged in fits and starts over the past two decades. He discusses some of the challenges that have faced the asset class in the country, alongside its prospects in the next years. Finland, he says, provides few built-in advantages for CTAs, but these can only succeed by providing a commodity 'niche' and attracting international investment.

A Slowly Emerging Asset Class

Class Karri Lehtinen describes the emerging culture of institutional and retail commodity investment in Finland as a protracted process spanning 20 years. He believes larger Finnish institutions have become very sophisticated investors nowadays, "with some even running their own hedge fund departments to diversify their portfolio and maximize their optimum risk/return parameters. Strategywise, they have the capacity to invest in many different types of commodity strategies," he explains.

"When I moved back to Finland in 1996," Mr. Lehtinen recalls, "commodity investments were in their infancy. Only a few physical operators, like Outokumpu and Neste, did active hedging on commodities in order to smooth their cash flow from sudden raw material price jumps that they worked on. Large institutions started to allocate more funds to commodities during the last so-called 'super cycle' driven by China starting in the early 2000s."

"First came various kinds of long only exposed commodity indexes that performed excellently, as they should do when commodity demand factors are strong," he continues. "Then, in the late 2000s, institutions moved towards more active investments products. In the beginning of the decade, large institutions allocated around 1-3% to commodities. Nowadays, the figure might be closer to 8-10%. Retail investors woke up following 2005, after commodity indexes had more than doubled since 2002."

"Electronic systems drive lots of ETF liquidity, amid other instruments new to markets that might push the market price even further than fundamental information would suggest. On the other hand, electronic trading systems with increased liquidity have removed limitations on the ups or downs experienced in the marketplace. I can remember times in 1990s when pork bellies were limited for up to almost two weeks! Can you imagine finding yourself on the wrong side of the market and then you can't get out of your position?"

Mr. Lehtinen has been a commodities trader since 1993 and he notes that market dynamics have changed a lot since then. "I have had some traders shift from trend and curve strategies towards volatility trading. Lots of commodity liquidity comes in a good macro environment, and it is then very difficult to analyze demand and supply scenarios with relation to specific commodities." Looking for reasons for the initially slow adoption of commodity investments by Finnish allocators, Mr.Lehtinen recalls the problems, for example, of explaining commodityreturn drivers to retail side investors. Retail investors soon learned about spot return drivers, but explaining curve or term structures was basically unheard of at that time. Even today he believes, retail investors are looking for returns on spot prices and nothing else. "In any event," Mr. Lehtinen suggests, "the Yale and Harvard Endowment Optimum Asset Allocation Method indicates that individuals should have 30% in real asset with along side their traditional investments, such as stocks and bonds."

Limited Exposure to Commodity Funds

“Nowadays, large investors all use commodity instruments, ranging from derivatives and indexes to mutual and hedge funds and ETFs,” says Mr. Lehti nen. “Commodity funds are used, especially if their strategy is a potenti al niche product off ering diversifying aspects. They are however required to have a sizable AUM of well over €100m in order to have even the slightest chance of att racti ng investment from the big players.

Smaller investors, for their part, invest in Commodity-structured notes, ETC’s and indexes.” Asked about a traditi on in Finland to invest in physical commoditi es, like gold and silver, to weather hard ti mes, Mr. Lehti nen explains that there have been a few asset management companies that sold physical gold and silver right aft er the fi nancial crisis and during the unrest in Europe. “I believe they were somewhat successful, but demand has dropped dramati cally aft er the return to a more stable economic environment. It is much easier and cheaper to buy ETF/ETCs and derivati ves than physical products with the same exposure.

There is, though, always some demand for physical gold, when ti mes get tough and stocks lose value.” “There have basically been index long only commodity products off ered by banks available since 2002,” he says. They were mainly sold in the period between 2002-06, when indexes gained around 40% per year, but these lost their luster aft er the fi nancial crisis due to the fact that all gains were lost across 2008-09.”

Finnish Horizons for CTAs

That same period of course was ferti le soil for CTAs and Managed Futures funds, and Mr. Lehti nen ascribes part of the emergence of Finnish commodity funds to the early role played by Estlander & Partners. “Estlander has been the most successful acti ve player and commodity service provider to both large and small investors, certainly in Finland, but to some extent also in Europe as well as in the U.S. Estlander has a long traditi on with commoditi es and is an acti ve manager, although they also trade other asset classes.”

Karri Lehtinen, MG Commodity Corporati on

Of his own experience, Mr. Lehti nen cites CFM Contango Fund Management, that ran acti ve long/short multi – strategies between 2006-12. However, “the company gained market share fast, but lost lots of AUM aft er the fi nancial crisis, even if its performance was no way near as bad by comparison to how much indexes lost value. It was at a ti me when many small companies lost AUM due to the uncertain ti mes. Since then, there have not been any other pure commodity funds coming up in Finland other than MG Commodity Corporati on Mr. Lehti nen’s current company, “which itself is in the start up phase.”

Despite the infrastructure, reputati on and skill Estlander & Partners brought to the small market, Mr. Lehti nen does not sense a spark went out to trigger more startups in the field. “I do not think there are any natural advantages to get started for a commodity manager in Finland. There is not enough of an investment culture or investable assets for this assets class locally. Basically, it is a matter of choice to operate a commodity fund in Finland, but one must be prepared to attract foreign investors to be successful. One’s product must be a true ‘commodity niche’.

However, markets will change a lot and regulation is already forcing both service providers and investors towards more regulated products and transparency. “In the next 10 years the majority of all funds in the Nordic area will be managed and valuated by respected large European fund administrators and their bank counterparts. Setups will be similar to what there is in Luxembourg, but spread out across all central European locations. This might be costly to investors, but it will leave fund managers more time to operate their strategies on behalf of the investor, rather than spending time on fund’s daily operational tasks.” To be successful in the Nordic area, Mr. Lehtinen is convinced one needs to be open-minded and maintain an international focus.