ABSTRACT

With the ongoing debate in the recent years, whether combining commodities with stock portfolio gives a better hedged position to an investor against the associated risk and volatility, there is an another view that what happens to these benefits in extreme environments. The paper focuses on diversification properties of commodities in a stock portfolio by studying the conditional correlations of commodity futures with stocks,its variation over time and their response to volatility in stock markets. The analysis is done for the Indian equity and commodity futures market, namely NIFTY Index and MCX Commodity Future Indices (Energy, Metal and Agricultural) over the period 2005-2014. We find that conditional correlations between commodity futures and equity returns fell over time, a sign that commodity futures have become better tools of diversification. The correlations with equity returns also fell in the periods of above average market volatility. We see this as affirmative news to long-term investors as they need the benefits of diversification most in the periods of high market volatility. The paper also studies the variations in conditional correlations around the Financial Crisis of 2008 and compares the MCX commodity futures indices in terms of their diversification properties in extreme environments.