Question #1 of 15

Which commodity is *most likely* to be characterized by large economies of scale in production?

A) Wheat.

B) Copper.

C) Cattle.

Explanation

Production of industrial metals such as copper has large economies of scale in mining and processing.

(Study Session 15, Module 45.1, LOS 45.b)

Related Material

SchweserNotes - Book 5

Question #2 of 15

Political risk is *least likely* to affect the price of which commodity?

A) Oil.

B) Coffee.

C) Industrial Metals.

Explanation

Political risk is an important concern affecting the supply of oil. Political risk (especially union strikes and restrictive environmental regulations) affects the supply of industrial metals. Softs such as coffee are more affected by weather and disease.

(Study Session 15, Module 45.1, LOS 45.a)

Related Material

SchweserNotes - Book 5

Question #3 of 15

An oil refiner wants to hedge oil price risk using a swap. The swap pays the oil price above $50 per barrel in exchange for a fixed price of $1 per barrel. The notional principal is 1 million barrels. If the refiner enters the swap, the total profit to the refiner if the price of oil is $52 is *closest* to:

A) +$1,000,000

B) $2,000,000

C) +$2,000,000

Explanation

An oil refiner would be concerned about oil prices rising (i.e. input costs going up) and hence would hedge their exposure by choosing to receive the return on oil (i.e., the difference between the market price and $50) and pay the fixed $1. In this instance the net payoff is ($52-$50)-$1 = $1 per barrel (recall that the notional is 1 million barrels).

(Study Session 15, Module 45.2, LOS 45.i)

Related Material

SchweserNotes - Book 5

Question #4 of 15

Don Chancery is working on a forecast of commodity price movements for the economic research department at his investment firm. He is basing his predictions on the theory that pricing is driven solely by producers who hold (or expect to hold) commodities, and hedge their position with a short futures contract, leading to normal backwardation. Which of the following theories is Chancery *most likely* using?

A) The Hedging Pressure Hypothesis.

B) The Theory of Storage.

C) The Insurance Theory.

Explanation

Under the Insurance Theory, the shape of the futures price curve can be explained by producers of a commodity (i.e. market participants that are long the physical good) selling the commodity for future delivery in order to hedge their exposure to price risk. The Hedging Pressure Hypothesis extends the insurance perspective to include consumers who hedge long positions, not solely producers with short positions. The Theory of Storage links convenience yields to inventory levels.

(Study Session 15, Module 45.1, LOS 45.f)

Related Material

SchweserNotes - Book 5

Question #5 of 15

As compared to a production value-weighted index, an equally weighted index would *most likely* have:

A) lower weight to oil.

B) higher weight to oil.

C) equal weight to oil.

Explanation

Production value weighted indexes have higher weight to energy (e.g., oil) as compared to equal weighted index.

(Study Session 15, Module 45.2, LOS 45.j)

Related Material

SchweserNotes - Book 5

Question #6 of 15

As opposed to stocks and bonds, commodities are *most likely*:

A) physical assets.

B) traded on futures exchanges.

C) characterized by lack of intrinsic value.

Explanation

As opposed to financial assets such as stocks and bonds, commodities are usually physical assets. While commodities do not have any cash flows, they do have intrinsic value and can trade in spot markets.

(Study Session 15, Module 45.1, LOS 45.c)

Related Material

SchweserNotes - Book 5

Question #7 of 15

Ben Tarson, CFA is currently undertaking an analysis of the commodity markets to present to a potential client. Part of his presentation concerns the impact short hedgers have on the price of commodity futures contracts. Which of the following market participants is *most* likely to take a short hedge position?

A) A hedge fund buying copper in the spot market and selling copper futures contracts.

B) Airline looking to purchase fuel forward.

C) Wheat farmer looking to sell wheat forward.

Explanation

The wheat farmer is looking to lock in the sales price of his product. This is a short hedge as the farmer will sell contracts. The airline is looking to undertake a long hedge and the hedge fund is looking to make an arbitrage trade.

(Study Session 15, Module 45.1, LOS 45.d)

Related Material

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Question #8 of 15

A commodity futures contract in contango will most likely:

A) entail purchasing more contracts to maintain same value exposure to the commodity.

B) entail purchasing fewer contracts to maintain same value exposure to the commodity.

C) lead to positive roll return.

Explanation

Contango markets have negative roll returns and entail purchasing fewer, higher-priced new contracts to replace the expiring lower-priced contracts.

(Study Session 15, Module 45.2, LOS 45.g)

Related Material

SchweserNotes - Book 5

Question #9 of 15

Roger Torsten is studying historical data on the commodities markets to assist with his a forecast he is producing in his role as an economic researcher. He has observed long periods in the past when the term structure of the futures market for a commodity displays a negative trend. Which of the following explanations is *most likely* an explanation for this observed trend?

A) Due to an increase in the supply of the commodity, the convenience yield has dropped to nearly zero.

B) Manufacturers, concerned about increasing commodity prices are buying commodity futures to hedge input costs.

C) Producers concerned about a potential drop in price of the commodity are taking hedging positions to lock in a sales price.

Explanation

Producers taking short hedges will force the futures price down and may well lead to backwardation. If manufacturers are taking out long hedges the term structure is likely to be in contango. High convenience yields would lead to backwardation.

(Study Session 15, Module 45.1, LOS 45.f)

Related Material

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Question #10 of 15

Which of the following statements regarding commodity returns is *least* accurate?

A) The collateral yield on a commodity futures position is negative if the convenience yield is lower than the storage cost.

B) A commodity futures market in backwardation will increase the return on an investor's position via a positive roll yield.

C) Due to roll yield and collateral yield, a commodity futures position may have a positive yield despite a drop in the spot price.

Explanation

The collateral yield is the return on the cash used to collateralize the futures position and is independent of the futures price.

(Study Session 15, Module 45.1, LOS 45.f)

Related Material

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Question #11 of 15

Which of the following statements regarding the pricing of commodity futures contracts is *most* accurate?

A) The convenience yield for a commodity is positively correlated with the futures price.

B) Commodities that are subject to sudden and large demand shocks may exhibit backwardation in the futures market due to significant convenience yields.

C) The arbitrage free price of a commodities futures contract is often lower than that of a financial security futures contract due to storage costs.

Explanation

Storage costs increase the price of commodities futures contracts. If a commodity is subject to demand shocks the benefit from holding the commodity is higher and hence the higher convenience yield may force the futures market into backwardation. Higher convenience yields reduce the futures price.

(Study Session 15, Module 45.1, LOS 45.f)

Related Material

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Question #12 of 15

Suppose that corn futures contracts are in backwardation. Which of the following is *least likely* to be true?

A) Spot price of corn is higher than the futures price.

B) the basis for corn futures contract is negative.

C) roll yield on the corn futures is positive.

Explanation

When the futures contract is in backwardation, the spot price is greater than the futures price and the difference between the spot and futures price (i.e., the basis) will be positive. If the market is in backwardation, roll yield will be positive.

(Study Session 15, Module 45.1, LOS 45.e)

Related Material

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Question #13 of 15

The current spot price of a commodity is $85.20. An investor purchases a 6 month futures contract on the underlying commodity at a price of $84.80. Which of the following statements regarding the roll yield is *most* accurate?

A) Roll return will only be positive if the spot price drops below $85.20 at maturity.

B) Roll return will only be negative if the spot price drops below $84.80 at maturity.

C) If the market stays in backwardation, the roll return will be positive regardless of the movement in spot price.

Explanation

Roll return reflects the convergence of the futures price to the spot price. When the market is in backwardation (futures price below spot) the roll yield is always positive.

(Study Session 15, Module 45.2, LOS 45.h)

Related Material

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Question #14 of 15

Which of the following commodities has historically been least likely to be traded globally?

A) Corn.

B) Natural gas.

C) Livestock.

Explanation

Historically, the US livestock industry has not been oriented towards export due to high spoilage risk. More recently, improvements in freezing technology have meant that livestock products (i.e. frozen meat) are now being traded globally.

(Study Session 15, Module 45.1, LOS 45.b)

Related Material

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Question #15 of 15

An investor establishes a long position in 800 WTI (oil) contracts at $45 per barrel. Which of the following components of investor's return will have a non-negative value?

A) rebalancing return

B) roll return

C) price return

Explanation

Rebalancing return is applicable on a commodity index (or portfolio) and is zero for a single commodity position.

(Study Session 15, Module 45.2, LOS 45.g)

Related Material

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