Book reviews

Commodity Derivatives: Markets and Applications
by Neil C. Schofield

Wiley, Chichester; 2007; ISBN 978 0 470 01910 8; 315pp; hardback; £60

Commodity price risk is one of four basic types of market risk. It is the oldest type of risk, and one for which hedging is conducted through the use of derivative instruments (this refers to agricultural commodity price risk). Due to the occurrence and the growth of price risk for many commodities, the market of commodity derivatives has grown substantially in the last decade.

There are at least two large groups of users of commodity derivatives. The first group contains all those entities involved in trading commodities. The group includes those producers and consumers of the particular commodity who are willing to hedge commodity price risk. The second group consists of different financial institutions, including investment funds and hedge funds. It is often the case that the investment portfolios of such institutions contain commodity derivatives.

This book provides a good point of reference for both groups, but also for other readers interested in the area of commodity derivatives. The book's author is a practitioner, and he mentions at the very beginning of the book: 'I have tried to write a book that documents in one place the main commodity markets and their associated derivatives'. The reviewer thinks that the outcome is a good book, although it is not easy to describe such a wide topic as commodity derivatives in around 300 pages.

The book is divided into 12 chapters, three of which are general in their nature, with the remaining nine (Chapters 3–11) describing specific commodities, markets and respective commodity derivatives. One very useful feature of the book is the synopsis commencing each chapter and describing the content of the chapter in a few sentences.

The first two chapters are introductory and present the construction of the four basic types of derivatives (options, futures, forwards and swaps), and the principles of pricing and basics of risk management for two groups of market participants, namely companies and investment banks. The interesting part of Chapter 1 is the presentation of the main pricing relationships for derivatives through the so-called 'relative value triangle'.

Chapters 3–11 have a relatively uniform structure, as they contain a description of the particular commodity (and also show its physical features), the patterns of supply and demand influencing the price of this commodity, examples of commodity derivatives (mostly from the over-the-counter market) and the application of these derivatives. An important and useful feature of the book is that each chapter discusses both spot and derivative markets.

The author has selected the following commodities to present in these nine chapters: gold, base metals (copper and aluminium), crude oil, natural gas, electricity, plastics, coal, emissions and agricultural commodities (corn, wheat and ethanol). It is worth mentioning that emission derivatives are also considered as commodity derivatives.

One might question the composition of these chapters, particularly that some (such as those presenting gold, crude oil and electricity) provide more details than other chapters. In addition, some commodities are not explored, such as some precious metals and some agricultural commodities. However, the composition of these nine chapters was to some extent determined by the limited number of pages available.

Although the structure of chapters describing particular commodities is roughly uniform, some issues do receive more attention, notably:

- producer and central bank hedging strategies in the gold market;
- option strategies in the base metal market;
- physical supply chain and price term structure in the crude oil market;
- regulatory issues within the electricity market (including three examples — Nordpool, USA and London);
- climate change and political issues in the emissions market.

The reviewer considers this choice to be a good decision of the author.

The final chapter is a general one, as it presents the commodities as part of an investment portfolio. In addition to reviewing groups of investors and considering the benefits of investing in commodities, the author provides a very useful discussion of investment methods as well as structured investments.

After reading this book, one is left with a very positive general impression. It is written in very clear language. The text contains a lot of useful information about this important group of assets. It is directed to practitioners willing to get acquainted with spot and derivative commodities markets, as well as those willing to learn about the applications of these instruments. In addition, it is a valuable resource for theoreticians and students.

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