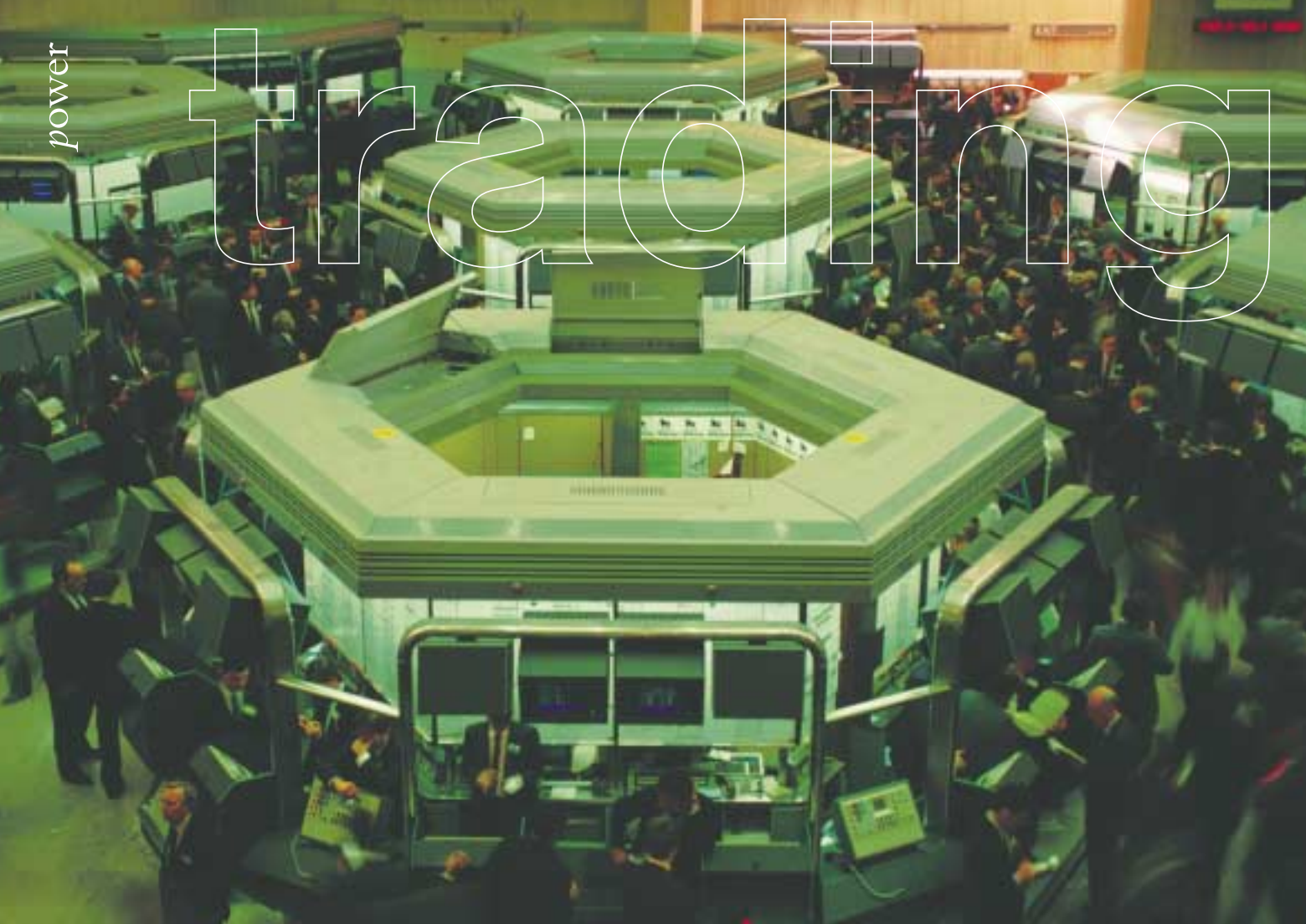


## trading



# Hedge Funds Heed Volatility's Call

By Coleman Fung

*Following Enron's collapse, speculative traders beat a retreat from energy. Now speculative trading has returned—and the indication is that money is there for the making.*

Volatility in energy commodities is attracting a raft of new investors. In particular, there has been a rise in the number of hedge funds and their counterparts picking up the distressed power generation assets of the mega players. Recent research indicates there are upward of 200 hedge funds actively engaged in energy trading today, using a diverse range of plays including energy commodity trading on the Nymex and over-the-counter markets, commodity/energy equity plays, distressed power asset plays and other financial instruments. Also, new energy-specific hedge funds are being created to deal in physical energy and derivatives. Many of these funds are being created by experi-

enced traders let go by gas/power merchants when they pulled back from speculative trading in 2002.

Although it is hard to quantify accurately the amount invested in the market by the various hedge funds, there is evidence of substantial activity. Nymex has seen a marked increase in energy futures and over-the-counter trading. But it is not only commodity trading. Investment funds and hedge funds are buying physical assets.

For example, the list of buyers for the UK gas distribution networks includes a number of utility/financial investor joint ventures. Merrill Lynch & Co. has agreed to acquire the energy trading operations of Entergy-Koch LP,

and Louis Dreyfus acquired some of ConocoPhillips' storage and pipeline assets, a natural gas liquids pipeline system, and a liquefied petroleum gas terminal from ExxonMobil Corp. Hedge funds and investment funds are also buying oil in the ground. In short, financial groups are banking on energy as a long-term investment and as a business where they can leverage their core strengths to profit within the current and emerging energy commodity markets.

## WHY ENERGY MARKETS?

So what is attracting hedge funds to the energy sector? Increased volatility has a large part to play. Energy commodities across the board are exhibiting increasing volatility due to supply-demand factors, partly as a result of long-term investment, currency fluctuations and political and regulatory issues. The price of oil is expected to continue to rise through 2005 due to constraints on supply and refining capacity and rising demand – particularly from the U.S., China, and India. Prices for crude oil and gasoline recently hit record highs on the back of hedge funds fleeing the falling U.S. dollar for the promise of quick money on futures contracts.

Supply/demand factors have also led to more volatile markets in gas and coal. The market for North American gas will continue to fluctuate due to a fall in production. Coal in particular has benefited from volatility in the gas market and a rise in demand from new coal power stations. Power markets also have seen substantial price spikes. The volatility of energy commodity prices provides tremendous profit opportunities for those with the right trading strategies, the ability to monitor their risk exposure properly, and the understanding of their positions at a moment's notice. Just how big are those opportunities? According to research by Peter Fusaro, chairman of Global Change Associates, and Gary Vasey, vice president with Utilipoint, some energy hedge funds are earning returns of more than 40%—four times that of traditional investments.

There is also a greater focus on utilities as investment stock. Global equity markets are flat, and there have been diminishing returns from traditional currency and fixed income markets. Utility stocks tend to be counter-cyclical—when the equity market is buoyant, it takes the shine off utility stocks; when the rest of the stock market takes a hammering, utilities do well because they are seen as a safe haven. Certainly, hedge funds and other investment vehicles seem far more willing to take a more direct part in the energy sector, whereas in the past they have generally been restricting themselves to indirect financing or involvement through the receipt of distressed assets. In fact, hedge funds are now the largest providers of debt financing to the old energy merchants, say Fusaro and Vasey.

Pension funds are also looking for higher returns and safe harbor through alternative investment strategies and are therefore channeling money into hedge funds. The lack of correlation between conventional markets and energy commodities offers a natural hedge against poor returns from

other sectors. According to research by Deutsche Bank, commodity markets were the best performing asset class in 2004. The Goldman Sachs Commodity Index shows total returns of more than 17% compared with just over 10% returns on the Standard and Poor's 500 Index.

What also makes energy markets alluring to institutional investors is that energy markets are immature compared to traditional commodity markets such as metals and agricultural commodities. Traditional commodity markets trade between six and 20 times the physical underlying market, Fusaro and Vasey point out. This indicates that the energy complex should be trading at least US\$10 trillion per annum by 2010. Today it trades around US\$2 trillion—half the physical market. Furthermore, energy markets are relatively opaque—so there is plenty of opportunity to gain a competitive advantage to an extent not possible in other markets. There are also increasing opportunities for investors in new markets, for example, renewable power and carbon emissions, particularly in Europe.

## THE CAST

The current cast of energy hedge fund players is very diverse, from a large number of boutique outfits (started/staffed by energy traders who used to work at big energy merchant firms), to many mid-sized funds and a small number of well-established household names (such as Tudor Jones and Citadel). Regardless of size, the value proposition of these energy hedge funds is the same: they are looking for and profiting from arbitrage opportunities in various energy markets within a range of leveraged environments. Some will do so with their proprietary models and analytics—usually internally developed or hybrid technologies—in highly leveraged environments; while others will try to accomplish the same by relying on their well-tested trading expertise—or gut instinct—with minimal credit lines.

On the well-established end, there are both types of major or mega funds: old-timers and newcomers. Regardless of history, the main attribute that differentiates these major fund players is their current commitment to the energy markets and investment in building their energy trading operations (e.g., hiring star traders and installing/building advanced trading and risk systems). Leveraging their prized trading and analytical infrastructure, they can arbitrage and trade a wide range of energy products—from highly structured instruments to plain vanilla deals—covering both physical and financial transactions. In other words, they are prepared for the long haul in the energy markets.

At the other extreme, there are a number of boutique funds that started as a result of the collapse of the major North American energy merchant firms. Former executives and traders at the once-mighty merchant firms formed many of these. Armed with the names and numbers of prominent energy players, several of these former executives/traders have been able to renew their energy trading careers by setting up their own funds or by joining the major fund players, banks

that are expanding their energy operations, surviving/thriving utilities, etc. In contrast to the wide-ranging trading capabilities and extensive credit facilities of the majors, these boutique firms trade mainly exchange-based instruments with limited liquidity. Nevertheless, they are thriving in their own ways because of their seasoned, “heuristic” energy trading expertise.

Ex post, we can all agree with the fact that the sharp pullback by energy firms and banks was overdone. While most traditional players such as energy merchants, utilities, commercial and investment banks were dramatically downsizing their energy trading operations, it was a few of the daring hedge funds—entrenched and new—that went against the trend and took full advantage of the arbitrage opportunity. Now, when trading volume is up, market liquidity is improved and major banks and energy firms are once again expanding energy trading activities, it is easy to forget that it was the hedge funds that were the first to hold the line and pioneered the turnaround in energy trading.

Like their counterparts in the fixed-income or currency markets, energy hedge funds thrive on market volatilities and inefficiencies. Because they are unregulated, they have far more flexibility to transact and structure deals than do banks and energy firms. Given the right conditions, they may develop the next “big thing” for the energy market.

Like everything else in life, there is always a catch.

Given the sizable pool of small funds, it may be difficult for some of them to continue to prosper and maintain that arbitraging edge as competition intensifies and margins shrink. Some will go out of business, while others may be forced to merge with bigger funds or be bought by banks expanding in energy trading. Since these smaller funds have limited capabilities of transacting deal type/size and accessing credit facilities, the potential consequences of anyone going down should be manageable.

But what about the large, well-established funds? What is the possibility of having an energy version of long-term capital management? There is always a possibility, but it should be small as long as both commercial and investment banks manage their credit facilities to these big funds rigorously. Besides, it is simply impossible to short that much power, gas or crude over the rapidly aging transmission infrastructure. The real test will come for the banks when their margins are squeezed; they will have to either accept lower profit margins or relax credit facilities so that they can trade more with the big funds. Will it be déjà vu all over again? Stay tuned. •

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