

The New Investors in Energy

For the average investor the energy industry has always offered opportunities to profit through the publicly traded securities available on the world's stock markets. Indeed, many multinational oil companies have long been considered "blue chip" stocks with both reasonable dividend and appreciation characteristics. Mutual funds have also provided investors opportunities to indirectly invest in the energy equities, although until recently usually as part of a more diversified approach. More sophisticated investors have had other options, including the use of options on securities and access to commodity trading through CTAs, hedge funds, and other alternative investment vehicles.

However, over the last two years, the energy industry has literally been transformed into the "hot" investment sector. Today, with high and volatile energy commodity prices impacting everyone, energy is in the news headlines 24/7. On a daily basis, new investment opportunities in the energy industry are offered in the form of energy or natural resource-specific mutual funds, exchange traded funds (ETFs), income and royalty trusts, master limited partnerships (MLPs), and other vehicles. The average investor now has a broader set of opportunities to participate in the booming energy sector. Yet these new vehicles only scratch the surface of the opportunities provided through the alternative investment universe via energy and environmental hedge funds.

NEW ENERGY INVESTORS

The new investors in energy are what we refer to as "the triangle of trading." These comprise investment banks, hedge funds, and multinational oil companies. Today, utilities are being increasingly marginalized in energy markets as they drop back into trading around their assets and pursue a strategy of optimizing those assets for shareholders if they trade at all. With

the energy merchants long gone after the fall of Enron and the others, a vacuum was left that these new investors have stepped in to fill.

The investment banks have been in and out of energy over the years to varying degrees, but over the last 18 months, the banks have increased their interest in and exposure to energy across the board. Almost every sizable investment bank now has a position in energy, while only Goldman Sachs and Morgan Stanley have had some form of presence for over 20 years. Other banks, including UBS, Barclays Capital, Lehman Brothers, Citigroup, Deutsche Bank, and ABN AMRO, among others, have all increased the size of their energy trading desks; and others, such as Merrill Lynch and Bear Sterns, have created joint ventures with, or even acquired, existing energy trading firms.

Investment banks continue to play a role on the distressed asset side of the energy business, too, while some have actually acquired significant energy assets and now operate those assets. For example, Goldman Sachs added to its energy portfolio with the purchase of East Coast Power and the acquisition of Cogentrix Energy in the United States. Both Goldman Sachs and Morgan Stanley can handle physical trading and take actual physical delivery of product. Goldman also holds a large renewable energy generation portfolio, too. Some investment banks have even bought oil and gas reserves in the ground.

The multinational oils have also moved in to fill the space left by the energy merchants in recent years. British Petroleum (BP) is now the largest trader of natural gas in North America, and it and other multinational oil companies have reported huge profits from their energy trading activities over the last 12 months.

However, the key area of interest and the topic of this book is the ever-growing and “secretive” hedge fund community. Despite increased interest from regulators such as the US Securities and Exchange Commission (SEC) and others, hedge funds are being funded at a record pace. Once the exclusive domain of private wealthy individuals, institutional money is now flooding into hedge funds seeking promised better returns (Figures 1.1 and 1.2). The \$38.2 billion that flowed into the funds in Q1 2004 was a record and that pace has continued as public and corporate pension funds now allocate an average of 5–7% of their assets for investment in hedge funds. Van Hedge Fund Advisors¹ recently issued a report in which it expects assets under management at hedge funds to double to \$2 billion by 2009.

But as hedge funds gain access to increasing amounts of capital, so too has the average hedge fund return declined to something less than spectacular. Hedge funds returned less than 9.64% in 2004, compared to 15.44% in 2003, and under-performed more conventional asset classes

according to the CSFB Tremont hedge fund index.² Hedge fund managers attributed their lower performance in 2004 to low volatility and low interest rates. As a result, hedge funds have been looking for other asset classes to invest in. Seeking new opportunities where the sparkle can be put back on their reputation for producing a significant return on investment, they have identified the energy industry as having that potential. Early indications have only served to raise energy's profile since some of the better performing funds last year were focused on energy.

As a result, those ex-energy traders from the merchant era are now back in demand. Energy traders are being snapped up by hedge funds, multinational oil companies, and investment banks, and, in some instances, they have formed their own hedge funds based on their energy trading expertise. Indeed, the number of specialist energy commodity trading funds with between \$1 million and \$25 million in assets under management is growing rapidly. Not all the energy funds are so small. Several of the better known energy-focused funds are quite large, between \$400 million and over \$1 billion in assets under management. But we are also seeing a trend for much larger (greater than \$1 billion under management) macro funds to switch more of their assets into energy, too. Today, our research has identified over 450 hedge funds that are active in the energy industry and that number continues to grow. Their assets under management range from \$1 million to \$2 billion.

WHY NOW?

Perhaps those of us in the energy industry have been too comfortable and too close to the business to notice the lack of sustained investment in our industry over the last 15 or so years. Whether it is oil and gas exploration, development of new reserves, or investment in the power industry, we are now seeing supply–demand tightness in all energy commodity markets and a historical under-valuation of energy companies and their assets. At the same time, demand has continued to grow robustly, and we are now at a stage where unforeseen events such as acts of terrorism, industrial disputes or accidents, weather-related events, and transmission constriction can be enough to create considerable concern about supply. This has resulted in increased price volatility, particularly in oil markets, and the funds love that price volatility.

There is now a growing awareness and even acceptance that in global oil markets supply tightness is such that OPEC no longer holds the swing vote on oil price formation. Today, oil prices are set by the trader's views on the NYMEX as much as anything else. News events such as those that occur

in Iraq, Nigeria, Russia, and Venezuela over the potential for or actual supply disruptions, combined with reserve estimate reductions by major oil companies and the lack of transparency into the true nature of OPEC's own reserves, are now sufficient to cause \$2+ daily swings in the oil price. Over the last two decades, oil companies have been more interested in buying back their stock to increase share price and please shareholders than in investing in new exploration or production activities. Wall Street just hasn't rewarded explorers and risk-takers, and the majors have not significantly increased their exploration and production budgets partly because other commodity markets, like steel, have also risen accordingly, adding to the expense side.

For each energy commodity the picture is similar. While oil is a global market and impacted by global events, regional natural gas, coal, and electric power markets are now often subject to similar supply tightness. The rush to natural gas-fired generation has helped to increase the perception of supply tightness in gas markets and the 2003 black outs did likewise for electric power.

Hedge funds like volatility. They like to identify trends and bet on those trends. Today they see that the trend in commodity prices has been largely up, and as they place their bets they are accentuating those trends. They are also followers and will follow each other, chasing the money and the returns. Some of the energy commodity trading funds had returns of over 40% during the past year and that has not gone unnoticed.

Similarly, as oil companies made money on increased commodity prices, their equities looked undervalued. Energy stocks, including oilfield services, looked the same. Also, the collapse of the merchant sector in the industry has created a significant distressed asset and debt play for the funds. As ex-merchants seek to raise cash by selling perfectly good assets, so the hedge funds have seen their opportunity, and today hedge funds are among the leading holders of ex-merchant debt backed by valuable collateral. Even as the industry seeks answers to its own problems, the hedge funds see opportunities in renewables and green trading, for example.

WHAT IS A HEDGE FUND?

A hedge fund is a type of "alternative" investment. The term "hedge fund" is a general, non-legal term that was originally used to describe a type of private and unregistered investment pool that uses sophisticated hedging and arbitrage techniques to trade in the corporate equity markets. While hedge funds have traditionally been limited to sophisticated, wealthy investors, over time, their activities have broadened into other financial instruments and activities. Today, the term "hedge fund" no longer really

refers to their hedging techniques, which they may or may not use, but it simply refers to their status as private and unregistered investment pools. They are usually unregulated.

Hedge funds are somewhat similar to mutual funds in that they are both pooled investment vehicles that accept investors' money and generally invest it on a collective basis. However, hedge funds differ significantly from mutual funds because they are not required to register under all of the federal securities laws. They have this status because they generally accept only financially sophisticated investors and do not publicly offer their securities.

Hedge funds are also not subject to many of the numerous regulations that apply to mutual funds for the protection of investors, such as those requiring a certain degree of liquidity, that mutual fund shares be redeemable at any time, protecting against conflicts of interest, assuring fairness in the pricing of fund shares, disclosure regulations, limiting the use of leverage, and more. This freedom from regulation allows hedge funds to engage in leverage and other sophisticated investment techniques to a much greater extent than mutual funds. Hedge funds are subject to the antifraud provisions of the federal securities laws.

Part of the difficulty in defining what constitutes a hedge fund is that other investors engage in many of the same practices. For example, investment bank proprietary trading desks take positions, buy and sell derivatives, and alter their portfolios in the same manner as hedge funds. Individuals and institutions buy stocks on margin, and even commercial banks will use leverage. For these reasons the line between hedge funds and many other types of institutional investors is blurred.

However, there has been a change in the status of hedge funds recently. On December 2, 2004, the US SEC adopted Rule 203(b)(3)-2 and related amendments under the Investment Advisors Act of 1940. The new rules will require most hedge fund managers to register as investment advisors with the SEC. The effective date for many of the provisions of the new rule was February 10, 2005, and all hedge fund managers had to be in compliance by February 1, 2006.

The United States is not the only country looking more closely at a variety of hedge fund regulation issues. The French Regulator has also adopted new hedge fund regulations, providing for the creation of single manager funds and revising the rules regarding the criteria applicable to investment by French funds in hedge funds. Other nations are following suit or have already acted.

Hedge funds are often labeled in the press as secretive and by inference as sinister. They have been blamed by the media, politicians, and others as

being behind the run-up in energy commodity prices, but, as we will show, this is grossly unfair on both counts. In the United States, hedge funds are not allowed to market themselves. They have to show that potential investors are properly qualified before they can send fund materials. This means that hedge fund websites are stark password-protected pages offering no explanation of what or who they are. It means that it is exceedingly difficult to obtain any information about the fund, its manager, and its strategy for making money. However, this is simply a legal requirement of being a hedge fund.

These funds have been justifiably criticized because of the lack of transparency in investment methods. For hedge fund investing to become more widespread, the issue of transparency has to be approached. A fine balance has to be achieved between risk exposure information for investors without position-level transparency, which may be detrimental to a fund's performance. A fund may also use proprietary strategies and trading tactics that are vital for the manager's success.

Outside of the United States, marketing and solicitation rules are different and more information can be readily obtained on funds in the United Kingdom, for example. In fact, several hedge funds, such as London-based RAB Capital, are actually publicly traded in the United Kingdom and therefore offer a significant level of transparency to potential investors and shareholders. The supposed secretive and therefore sinister nature of the funds is in fact something largely dictated to them under law and regulation. We suspect that they would like nothing better than to build their own brands, profiles, and investor base if they were permitted to, just like any other business.

Alternative investments, and hedge funds, in particular are now widely acknowledged as a source of enhanced return compared to traditional portfolios. A number of strategies are available to the hedge fund manager to take advantage of declining as well as rising markets. Alternative asset managers aim to generate high rates of return for a given level of risk, regardless of market trends. Contrary to the sometimes prevailing public opinion, intelligent and effective risk management is a core component of each hedge fund strategy.

Hedge funds offer investors a number of advantages over other types of investment including, for example:

- instant portfolio diversification
- products can be created and structured quickly to meet the demands of a client

- they have traditionally offered superior risk-adjusted returns over the long run, with better downside protection over other investments
- absolute performance orientation, which can deliver positive return in all market conditions
- the potential for low correlation to traditional asset classes, particularly fixed income.

Another type of fund that has gained in popularity among certain types of investor is the fund of fund (FoF) or multi-manager fund. A fund of fund is a managed portfolio of other hedge funds designed to provide greater risk diversification among a set of strategies, and investors in funds of funds are willing to pay two sets of fees, one to the fund-of-funds manager and another (usually higher) to the managers of the underlying funds. The fund of fund may be actively managed, meaning that the actual investments in other funds can change through time. The fund of hedge funds will be dealt with in more detail in Chapter 9, but according to Vann Hedge Fund Advisors³ there are now over 3,000 fund of hedge funds compared to less than 50 in 1990, holding about 40% of the industry's assets. There are also investments known as fund of fund of funds, where investors of fund of funds invest in other fund of funds.

US HEDGE FUND REGULATION – A BRIEF UPDATE

As stated above, on December 2, 2004, the US SEC adopted Rule 203(b)(3)-2 and related amendments under the Investment Advisors Act of 1940. The new rules will require most hedge fund managers to register as investment advisors with the SEC. The effective date for many of the provisions of the new rule is February 10, 2005, and all hedge fund managers must be in compliance by February 1, 2006.

The new rules essentially require that advisors of “private funds” with more than 14 clients (more than 14 investors on a look-through basis) during the previous 12 months are required to register as an investment advisor if they have at least \$30 million in assets under management. Also, they would be permitted to register if they have at least \$25 million in assets under management. The SEC defined a “private fund” as an entity that:

1. Would qualify as an investment company under the US Investment Company Act of 1940 as amended if not for the exemption in either section (c)(1) or 3(c)(7) of the Investment Company Act;

2. Permits investors to redeem their interests within 2-years of purchase (lock up period); and
3. Offers its interests based on the investment advisory skills, ability or expertise of the investment advisor.

The new rules also require offshore advisors to look through all funds that they manage, whether or not those funds are located offshore and count as clients any investors that are US residents. Any offshore fund that had more than 14 US resident investors over the past 12 months would generally have to register also. The US resident designation is made at the time of investment in the private fund. An exception to the definition of “private fund” is included for a company that has its principal office and place of business outside of the United States, is regulated as a public investment company under the laws of a country other than the United States, and makes a public offering of its securities outside the United States in the same jurisdiction in which it is regulated as a private investment company.

Additionally, a registered investment advisor is generally prohibited from charging a client fees based upon capital gain or appreciation (meaning performance fees), unless the client is a “qualified client” (meaning a person or entity that has at least \$750,000 under management with the advisor, has a net worth of more than \$1.5 million at the time of the investment, or is a “qualified purchaser” as defined in the Investment Company Act). There is a “grandfathering” provision to allow investment advisors to maintain current fee arrangements with existing clients.

The new rules include a number of other provisions, such as modified record-keeping requirements, custody rules, and that readers should review the complete SEC rules for themselves.

Registration with the SEC as an investment advisor includes full compliance with the Advisors Act such as:

1. the preparation and filing of form ADV
2. the prohibition against charging performance fees to new investors who do not qualify as “qualified clients”
3. the adoption of written compliance procedures and the appointment of a chief compliance officer
4. the adoption of a written code of ethics
5. certain disclosure requirements upon payment of a cash referral fee to third-party placements agents
6. enhanced record-keeping requirements

7. additional reporting and audit requirements if the advisor has custody of its clients' assets
8. periodic inspections by the SEC.

One potential impact of the SEC registration requirement is a move to lengthen lock-up periods. Historically, lock-up periods had been 12 months, but recently managers have begun offering reductions in performance fees for longer lock-up periods. By lengthening such periods beyond 24 months, funds might avoid being defined as a "private fund," and hence work around the new rules. The two-year lock-up rule was apparently intended to distinguish between hedge funds and private equity funds, but may now be potentially used to avoid registration.

WHO INVESTS IN HEDGE FUNDS?

It is generally estimated that 80% of all hedge fund assets belong to high net-worth individuals. This group of investors was the first to massively allocate assets to hedge funds. Currently, US "accredited investors" (minimum \$1 million net worth) are reported to have 8–10% of their portfolio allocated to hedge funds. But institutions have been increasing their allocations to hedge funds at a rapid pace, too.

According to Van Hedge Fund Advisors,⁴ about 60% of US foundations and endowments, and around 20% of pension funds, have invested in hedge funds. European financial organizations are also known to allocate on average 1.3% of their total assets under management to hedge funds, and researchers believe that this percentage will rise above 5% in the future.

Some institutions are going still further. Some actually buy an entire fund; for example, Unicredito's purchase of Momentum Asset Management and JP Morgan Chase's purchase of Highbridge. Yet others set up an in-house fund of hedge funds (for example, the traditional manager Jupiter) or chose to establish an independent alternative investment firm. Institutions investing in hedge funds encompass many different sectors: portfolio managers (including private banks), insurance companies, corporate treasuries, pension plans, college endowments, and foundations. In all cases, the growing acceptance of hedge funds as a vehicle for institutional investment means that the available capital will continue to grow significantly.

Another survey by Prince & Associates⁵ also shows that about 45% of family offices are invested in fund of hedge funds, and this is set to grow significantly. Family offices are the world's private investors who invest the

monies of high net worth (HNW) individuals. Since the 1980s most hedge fund investing came from HNW individuals and private banks. This is also now changing with the bulk of the new exponential growth coming from insurance companies, pension funds, and endowments.

The 8,700 hedge funds with around \$1,000 billion in assets under management is double the number of hedge funds in 1999. It demonstrates the rapid growth of the hedge fund as a popular investment vehicle among particular groups of wealthy investors. The asset management industry is changing rapidly. The poor performance of traditional and index tracking funds in past years and the success of many individual hedge funds with different strategies, have shown that alternative investments are a plausible means to invest. Alternative asset management differs from traditional asset management in its dynamic investment strategies, and hedge funds form the most dynamic sector of asset management today.

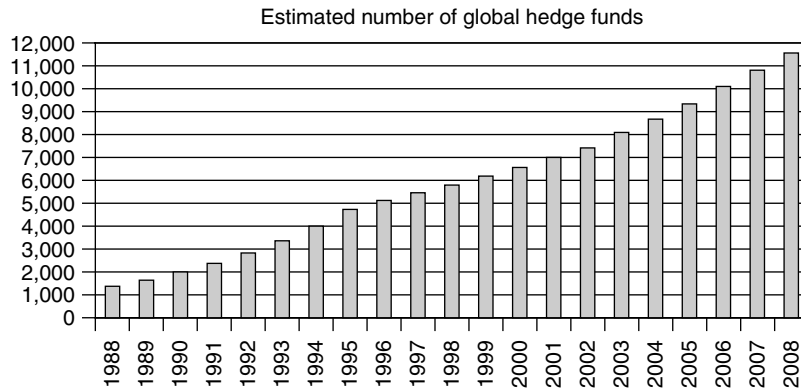
Stimulated by strong interest from sophisticated investors, this sector continuously attracts highly creative talented managers and enjoys sustained growth. The low correlation of hedge funds to equity and bond markets has become an increasingly important consideration for investors. Additionally, the effects of globalization have reduced the investor's ability to achieve meaningful diversification through geographical spreads across traditional markets.

Over the past decade, hedge fund assets expanded dramatically; from US\$20 billion to almost \$1 trillion today, and estimates are that they will reach over \$2 trillion in five years.⁶ There may be another 7,000 funds by then. In this decade the number of hedge funds has increased from 200 to more than 8,000 equally divided between the United States and offshore funds. However, some experts argue that hedge funds are experiencing a phase of consolidation, after which only 1,000 funds with an average size of \$200 million (instead of \$50 million today) may remain. That is highly debatable.

Hedge funds can take both long and short positions, and use leverage through financial derivatives in concentrated investments in order to maximize their profits. Their fund managers typically have a portion of their wealth tied up in the fund so that their relationship is in alignment with their investors.

Hedge funds have become a standard allocation class for corporations such as General Motors, educational institutions such as Harvard and Duke Universities, and state and local government pension funds. In Europe and Asia the boom is also underway. Germany has loosened its requirements so that there is no minimum investment requirement. In effect, they sell them to the retail market. But in reality there are only two hedge funds there at

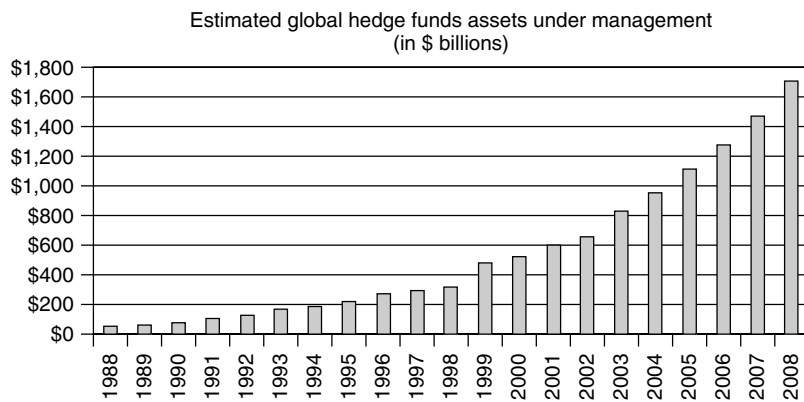
FIGURE 1.1 Growth of global hedge funds



Note: Estimates for 2005–2008 are projections based on current data and may be revised in the future. © 2005 Van Hedge Fund Advisors International, LLC and or its affiliates, Nashville, TN.

Source: www.hedgefund.com

FIGURE 1.2 Growth of hedge fund assets under management



Note: Estimates for 2005–2008 are projections based on current data and may be revised in the future. © 2005 Van Hedge Fund Advisors International, LLC and or its affiliates, Nashville, TN.

Source: www.hedgefund.com

present. Singapore is allowing a tax holiday in order to attract hedge funds to establish there.

It should be pointed out that over 70% of hedge funds have less than \$100 million to invest and are thus not necessarily good candidates for institutional investors, although that criterion may change for energy hedge fund investing. In the past, investors waited for funds to develop a 3- and

5-year track record, and could wait for funds to grow to acceptable size before investing. However, that is now changing and huge capital inflows coupled with the relatively few number of “institutional quality” funds will cause funds to grow very quickly. Therefore, investment decisions will need to be made quicker with less reliance on long-term track records. This is creating new investment criteria for the hedge fund industry.

According to Strategic Financial Solutions,⁷ of the 8,000 or so distinct hedge funds and funds of hedge funds in 2004, approximately 5,500 were single manager hedge funds and accounted for over \$1.5 trillion under management. They also found that nearly 175 of these funds have already surpassed the \$1 billion assets under management mark, but that the majority manages less than \$25 million. About 2,600 funds of hedge funds exist and manage approximately \$415 billion in assets, but the majority of funds of hedge funds manage less than \$50 million. The survey also found an additional 650 commodity trading advisors managing approximately \$81 billion, with over 40% managing less than \$25 million.

Worldwide financial assets are estimated at \$126 trillion and the funds are now estimated to engage 0.8% of that amount. It is still really quite small.

THE BASICS OF HEDGE FUND INVESTING

As potential investors in a hedge fund, individuals first have to meet certain standards as HNW individuals, including, for example, having a net worth of \$1 million or at least \$500,000 under management with the advisor. Under Section 205(a) and Rule 205-3 of the Investment Advisors Act, investment advisors are prohibited from receiving hedge fund-like compensation based on a share of the gains, unless certain conditions are met. One of those conditions is that the advisor’s clients are “eligible investors.”

Should you be eligible to invest in a hedge fund you will then be subject to certain fees and conditions. The fees will include a management fee of between 0.5 and 2% (although some high-performing energy funds are charging more) on your entire holding in the fund, and a performance fee of around 20% assessed on gains over a 12-month period. Performance fees may include a hurdle rate that is usually tied to a benchmark rate, and/or a high watermark. For the manager to take a performance fee the return on the fund must be more than the hurdle rate and the fee will be paid on the portion of the return that is above the hurdle rate. A high watermark may also come into play. This provision means that investors only pay a performance fee on the actual gain in the 12-month period. So, for example, if the fund’s net asset value (NAV) fell 10% during the year

and then recovered to return a 15% return for the year, the investor pays performance fees only on the 15%, as opposed to the 25% gain that the fund experienced from its lowest NAV during the year.

For funds of hedge funds, the fees are generally lower to the fund of hedge funds manager; typically around a 1% management fee and a less than 10% performance fee. However, the investor is in effect paying two sets of fees: one for the fund of fund manager and another for the underlying hedge fund investment. Over the last year or so, fund of hedge fund fees have been facing some downward pressure from investors.

Additionally, the investor may be subject to a lock-up period during which monies may not be withdrawn from the fund. Typically, this has been three to six months, but lock-up periods are widely variable and may extend as much as two or more years, depending on the fund's strategy. The lock-up period is designed to insure that new investors give managers sufficient time to put their money to work. Recently, some funds have considered more than two-year lock-up periods to avoid SEC registration via a loophole in the regulation. After the lock-up period, investors are also subject to a redemption notice period of a month to three months or so, with a penalty payment for early redemption.

Terms and conditions vary from fund to fund and may include other restrictions and provisions beyond those general ones discussed here. We recommend that you fully understand all of the terms and conditions prior to making any investment in a hedge fund.

TYPES OF FUNDS

Of course, there are many different types and styles of hedge funds to choose from. But, according to Eichengreen and Mathieson⁸ there are really three major classes of funds:

- macro funds, which take large unidirectional positions based on a top-down analysis of macroeconomic and financial conditions
- global funds, which take positions worldwide but employ bottom-up analysis
- relative value funds, which take bets on the relative prices of closely related securities.

Despite these, hedge funds usually follow a strategy. Most hedge fund strategies are market neutral as they make their money on the arbitrage between markets or individual securities, rather than betting one way or the other. That may not be true of energy hedge funds as the energy trader's mentality is often to take a "view on the market."

The following list defines a number of strategies employed by hedge funds.

Relative Value Strategies

- Equity market neutral – This seeks to profit by exploiting price inefficiencies between related securities, neutralizing exposure to market risk by combining long and short positions.
- Convertible arbitrage – This involves purchasing a portfolio of convertible securities and hedging a portion of the equity risks by selling short the underlying common stocks.
- Fixed-income arbitrage – A market neutral hedging strategy that seeks to profit by exploiting pricing inefficiencies between related fixed-income securities, while neutralizing exposure to market rate risk.
- Fixed-income – This invests in non-investment grade debt. Objectives may range from high current income to acquisition of undervalued instruments. Emphasis is placed on assessing credit risks of the issuer. Some of the available high-yield instruments include extendible/reset securities, increasing rate notes, pay-in-kind securities, step-up coupon securities, split coupon securities, and usable bonds.
- Fixed-income, mortgage-backed – Invests in mortgage-backed securities. Many funds focus on AAA-rated bonds.

Event-driven Strategies

- Distressed securities strategies invest in, and may sell short, the securities of companies where the security's price has been impacted by a distressed situation such as reorganization, bankruptcy, distressed sales, and other corporate restructuring.
- Merger arbitrage/Risk arbitrage – Merger arbitrage is also sometimes called risk arbitrage and involves investment in event-driven situations such as leveraged buy-outs, mergers, and hostile takeovers.

Other Strategies

- Equity hedge – Comprises long stock positions with short sales of stock or stock index options/futures. Has a long market bias.
- Sector composite – Invests in specific sectors. Primarily long energy, financial, healthcare/biotechnology, real-estate, and technology sectors.

- Emerging markets – Invests in the securities of companies or the debt of developing or emerging countries. Investments are primarily long.
- Global macro – Involves leveraging investments on anticipated price movements of stock markets, interest rates, foreign exchange, and physical commodities.
- Short selling – Involves the sale of a security not owned by the seller. It is a technique used to take advantage of an anticipated price decline.

Additional characteristics of hedge funds that should be borne in mind are as follows:

- many, but not all, hedge fund strategies tend to hedge against downturns in the markets being traded
- they are flexible in their investment options (can use short-selling, leverage, derivatives such as puts, calls, options, futures, and so on)
- they benefit by heavily weighting hedge fund managers' remuneration toward performance incentives, thus attracting the best brains in the investment business.

Additionally, as mentioned above, there are funds of funds too.

AN INTRODUCTION TO ENERGY AND ENVIRONMENTAL HEDGE FUNDS

The energy industry has come into sharper focus for hedge fund investing over the last 18 months because of the lack of opportunity in other markets and more recently the bull run in energy. Lower hedge fund returns are sparking much of the interest, but many of the larger macro funds view energy as an asset diversification play where they have been traditionally underweighted in investment. For example, the CAN\$550 million Sprott Canadian Equity Fund significantly shifted its portfolio over 2004 to become more deeply involved in the energy segment by increasing its exposure to these markets to 40% of its assets.

Generally, the traditional classifications of hedge funds don't fit energy hedge funds very well. For that reason we have developed our own classification of energy hedge fund strategies that is discussed in more detail in Chapter 2. In fact, despite the interest in energy and the existence of more than 450 hedge funds with some energy interest, the energy industry as an investment opportunity poses some problems for traditional hedge fund managers and investors. Sophisticated investors, fund managers, and the financial press still do not appear to understand what is happening in

the energy patch and in energy hedge funds. In private meetings with fund managers interested in energy, we still have had the uphill task of explaining that no track record in the hedge fund industry is not necessarily such a bad thing. Capable traders at banks and energy companies can show returns and have track records outside of hedge fund “land” to review.

Energy doesn’t fit the traditional hedge fund mold. And yet there are over 450 funds out there, and growing in the energy and environmental fields. In our meetings with existing hedge fund managers, we have found that the opportunities in the energy complex are still relatively misunderstood and that to leverage these opportunities might well require a slightly non-traditional approach on the part of many investors. The most insurmountable barrier to entry into energy hedge fund land is the lack of knowledge of the world’s largest and most complex business, which is rife with opportunity. Energy is the new kid on the block and it is still unfamiliar territory to many in the financial community. Yet the interest is there.

Another thing that we have learned is that investors, particularly institutional investors, like to look for younger managers early in their careers. This means a manager in his or her early thirties who has just started a fund. The theory is that the manager is hungry and the strategy will pay its largest returns earlier in its history. Interestingly, however, in discussions with other hedge fund managers we have heard conflicting opinions, such that the lack of at least a 24-month track record was considered a significant impediment. Perhaps this is simply related to the potential investor appetites on the parts of the funds and investors we have met with, but in energy, particularly energy commodities, our preferred managers would have some gray hair! Energy is a complex business and it has been moving sideways for 15 years or so. What we would want to see is someone who has been around long enough to have experienced both bull and bear energy markets and who understands these markets very well. On the other hand, as fund managers they need not have a long track record in managing a fund so long as they have a good track record as energy traders! In fact, given that most energy commodity funds have less than a two-year track record this is the only way to consider investing in the fund.

Notwithstanding the interest in the energy complex and its emerging environmental overlay, energy hedge funds are in something of a class of their own. Energy is an attractive asset class, but it is one that is just different enough to traditional investment opportunities to require a slightly different classification of strategies, a slightly different approach to manager selection, and due diligence. Energy is a risky business and neither those risks nor the underlying physical complexities are adequately

understood by many in the financial community. However, as the number of energy funds grows and as the quality of the returns are observed, the interest and the willingness to change the model slightly will be there.

NOTES

- 1 “Hedge Fund Demand and Capacity 2005–2015,” the Van Companies, August 2005.
- 2 CSFB Tremont hedge fund index, www.hedgeindex.com.
- 3 See (1) above.
- 4 See (1) above.
- 5 See (1) above.
- 6 See (1) above.
- 7 Strategic Financial Solutions, LLC – Database Study 2004.
- 8 Eichengreen and Mathieson, “Hedge Funds: What Do We Really Know?”, International Monetary Fund report, September 1999.

