Energy & Environmental Hedge Funds

By Peter C. Fusaro

WE ARE NOW in the fourth year of the strongest energy commodity market in history and continue to see the launch of many hedge funds, each pursuing different market strategies. When we began tracking energy hedge funds in October 2004, there were 180 such funds in our universe.

As of August 1st 2007, we now track 586 energy and environmental hedge funds through the ***Energy Hedge Fund Center***. According to our classification system, the funds are distributed as shown in Tables 1 and 2.

The latest trends in new energy and environmental hedge fund launches are as follows:

- Another round of commodity funds have been launched in the last few months. Many tend to be more broader-based than in simple energy while the reminder appear firmly targeted on European regional energy markets.
- Fund-of-funds in natural resources and environmental markets are in vogue and being created at a rapid pace.
- Water is increasingly a focus for funds with a small number being launched in the last few months.
- Everyone wants to get into the environmental markets and we see funds being launched with different environmental spins across the spectrum (carbon being the dominant fund strategy).
- Finally, commodity hedge funds are moving into the physical side of the energy industry.

Table 2 shows that North America and Europe continue to dominate energy and environmental hedge fund activity, but we expect to see more funds in Asia in coming years. This is particularly true for commodity hedge funds which are continuing to grow throughout the world.

Hedge Fund Trends

Many of the best funds are full to capacity and are largely becoming unavailable for new investment. This impacts fund-of-funds investment as negotiated capacity rights are increasingly needed to achieve superior returns. This problem will not disappear, as the proprietary trading divisions of investment banks used to be the training ground for the next generation of hedge fund managers. This has been eliminated in favour of direct hedge fund investment by the banks. While some future hedge fund managers will be spun out of the top tier hedge funds, the numbers will be dwarfed by those that were lucky enough to be in formal bank training programmes.

Investors continue to clamour for green investments, but the capacity is still limited

The issue of fund-of-fund access will become even more important in coming years. While there are several new energy and environmental fund-of-funds, the most established ones have been around for several years and have better access to fund managers.

Table 1: Fund Distribution

By Fund Strategy	
• Long/Short Equity	200
• Commodity	196
• Fund of Funds	46
• Hybrid (Equity/Commodity)	44
• Alternative Energy	36
• Infrastructure	17
• Water	2
• Shipping	4
• Unclassified	41
Total	**586 Funds**

Source: Energy Hedge Fund Center LLC

The New Flavour of Hedge Funds

Investors continue to clamour for green investments, but the capacity is still limited. While untold billions are waiting to be deployed in the clean energy and technology sectors, hedge fund capacity is limited. The better strategy may be to deploy capital in increments as the market continues to mature. Otherwise, there may be a tendency to deploy capital in more risky strategies. Market immaturity for all things green does not bode well for impatient investors clamouring for returns. Whilst we see green investments as an asset diversification strategy, investors must be cognisant of the risks in this early stage emerging market.

The market size today for all environmental financial commodities is only US$41 billion, but doubling every year.

Table 2: Fund Location

By Fund Location	
USA	384
UK	82
Canada	38
Switzerland	28
Norway	10
Holland	6
Australia	6
France	6
Hong Kong	5
Others	21
Total	**586 Funds**

Source: Energy Hedge Fund Center LLC

Green Investment Opportunities

I recently spoke at the Managed Funds Association (MFA) annual meeting in Chicago on green investment opportunities. The MFA is the premier association for hedge funds, and the participants are very senior management and run big portfolios. I was bowled-over with the enthusiasm for carbon trading in the ethanol capital of the world, and centre of the agricultural commodity world. Everyone now wants in and that's a good thing. But I always say "Get to know your risk!"

Carbon is the most complex commodity market ever created, and the money guys and gals are now extremely interested in deploying capital into the sector.

That applies to carbon dioxide, sulphur dioxide (the cause of acid rain) and nitrous oxide (the cause of ozone depletion) trading. However, the size of this market opportunity is immense. Carbon as a commodity will trade at least US$3 trillion and probably more. A back of the envelope estimate is that today's carbon footprint of 27 billion metric tonnes (CO_2 equivalent) creates an US$800 bn market, [multiply that amount by US$30–40 per tonne and that gives you the market size]. Since commodities usually trade 6–20 times the underlying physical market, we are talking about a very significant marketplace for carbon trading and asset management.

Another positive ingredient in the market's development (to throw in with carbon) is socially responsible investing with sustainable returns (SRI). Carbon could become the mother of all commodity markets due to the cross commodity arbitrage between fossil fuel energy contracts (oil, gas, power and coal) and agricultural commodities. That brings in exchanged traded futures contracts at the CME Group, the Chicago Climate Exchange, the New York Mercantile Exchange and the IntercontinentalExchange, to name a few. Add in OTC clearing and global commodity market linkages, and you see sizable global scale for this market maturation trajectory.

Carbon is the new gold and the next financial marketplace. Today, there are over 60 carbon funds, with 3 multi-billion funds in that group (RNK Capital, Climate Change Capital and Natsource), and three fund-of-funds (Kenmar, RMF & Parker Global Strategies) that we are aware of. We expect many more environmentally focused hedge funds and fund-of-funds to develop.

However, the problem facing this new market is not lack of capital, but lack of good managers. One senior banker recently commented to us that carbon markets are pure "information arbitrage" – which means those with the best access to information will achieve superior returns. That was clearly the case with the market meltdown in Phase I of the EU ETS in April last year, when some savvy carbon market managers maximised their short positions and did not lose much value the week when CO_2 prices fell from EUR30 to EUR9/tonne. A long-only strategy in carbon, which is the bias in the market, can be disastrous.

In this new era of carbon market development, it is necessary to keep a carbon inventory at all US, European and Asian companies as a reference. That leads to emissions trading through both voluntary and mandatory markets which have their own 'learning curves'.

The ultimate goal on the carbon roadmap is the promised land of a low carbon economy – still decades away. The present reality is that emissions continue to grow each year (with or without the Kyoto Protocol). Carbon asset and risk management are now poised to take off. Beware, however, as this is going to be a bumpy ride.

More Energy & Environmental Hedge Funds to Come

Despite all the recent turmoil triggered by the US subprime mortgage debacle on hedge funds, we expect many more energy and environmental hedge funds to spring up next year. This is because these markets are still financially immature. We view the energy trading market in all structures at US$3 trillion in notional value and rising, while the global energy market is over US$5 trillion in size, and rising. The more immature environmental financial markets are US$41 bn. The carbon markets are positioned to be the first global commodity market since oil. It is the money and the confluence of market drivers – such as higher sustained energy prices, rapid technology shifts and global environmental standards – that is accelerating interest in energy and environmental markets, driving capital deployment into this sector. Hedge funds are the pioneers in these markets and are willing to assume more risk than investment banks. They are 'morphing' into project financiers in new energy and clean technology – a role that was not predicted.

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Additionally, there is an expectation that there will be more hedge fund market blow-ups ahead due to their weaker capital base (certainly compared with investment banks), but that goes with the territory. It has always been said that energy is a risky business, but with that risk comes reward. Stellar energy and environmental hedge fund managers can show superior returns year in, year out. This sector is an asset diversification play for investors, many of whom unfortunately do not know it well. It is this lack of research and real due diligence, rather than routine box checking, that dissuades investors from taking the plunge into the best market opportunities.

The next new wave of activity is more green fund-of-funds. Expect an avalanche as investors go for green exposure with less risk •

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