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Study Finds More Than 200 Hedge Funds in Energy Markets

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It has been more than two years since the collapse of the industry's merchant segment, but the energy commodities trading markets have just recovered. Now, liquidity and market making is being provided by a surprising source, energy hedge funds, and is putting energy trading back on the scene.

Hedge funds are essentially un-regulated private investment funds that seek to profit from non-traditional opportunities using alternative investment strategies. UtiliPoint, in association with Global Change Associates' research, has identified more than 200 hedge funds in the energy trading space with more in formation throughout the world. It's almost as if energy is the only game in town promising higher returns than world equity markets due to its continuous price volatility across the energy trading complex. Oil, gas, power and coal exhibit tremendous daily and annualized price volatility and this seems to be increasing. The liquidity provided by the hedge funds is evidenced on the front end of the markets through both NYMEX and IPE oil and gas futures trading, but is much more established in the Over the Counter (OTC) energy markets. Like the hedge funds themselves, these markets are not price regulated, and have a degree of price opaqueness.

Hedge Funds May Be Here to Stay

The mainstream news reports that the funds “are in” and then the funds “are out.” This misjudges and understates the real importance of the entrance of hedge funds into energy trading. While it can be argued by some old time traders and brokers that we have had commodity pools of managed futures for more than three decades, that misses the point in view of the current scale of the funds' activity. Energy is the flavor of the year. It's in the news everyday and is now seen as a business where

money can be put to work. Indeed the scale of the market shows that it has a steep market maturation process ahead of it. Twenty-six years after the first financial futures contract for energy was launched on the NYMEX, we are still only trading about half of the physical value of the $4 trillion physical energy complex. There is tremendous opportunity for this market to grow, absorb risk capital, and actually become more volatile.

But, There are Warning Signs

There are essentially two main types of funds entering energy trading: the macro funds with assets under management often in excess of $2 billion that now have a proportion of their funds in energy, and the energy-specific funds created to trade energy by ex-merchant energy traders. It is the former, the macro fund traders with their black boxes and macro models, that are essentially clueless about the underlying complexity of energy. They follow general market trends using black box algorithms and while so far many have done well in crude oil futures markets, at least one took a bath by shorting (a move designed to profit on prices moving down) the market. In fact, our study has disturbingly revealed that there may be a good deal of ignorance and perhaps even some arrogance, on the part of these well-capitalized neophytes new to energy trading. Energy trading and risk management is the most complex, volatile market in the world. Its prices are influenced by weather, geopolitical factors, supply/demand fundamentals, news, and many other factors that cannot be quantified into simple black box algorithms.

Meanwhile, the energy specific funds, often a good deal smaller in terms of assets under management, are often founded and led by ex-energy traders. Our study has identified numerous such funds mostly set up in the recent past and, with new energy-specific funds being announced with increasing frequency, this represents an identifiable trend. In general, these funds are not limiting themselves to energy commodities markets but are using their energy industry knowledge to participate in physical markets and other energy commodities including electric power and natural gas. In fact, one such fund apparently made its investors about a 20 percent return on investment in its first month of operation.

Plainly, the entrance of hedge funds is reigniting the energy trading phenomena. By increasing liquidity through the introduction of additional risk capital and by improving the counterparty credit situation with strong balance sheets, the funds are providing the market some positives. However, the lack of detailed physical energy knowledge and reliance on black box models by some in the hedge fund community combined with the lack of visibility into their activities also ought to cause some unease and concern. The last thing the energy markets need is yet another speculative trading -led implosion.

Investment Banks and Multi-Nationals Also Increasingly Active

Those that get it right most of the time are the multi-national oil companies and the two big investment banks—Morgan Stanley and Goldman Sachs. These entities have maintained a consistent presence in energy trading markets for decades and have the knowledge base to put many of the hedge funds to shame. The energy trading winners will most likely be those two banks and some savvy energy trading companies that know both the energy markets *and* risk.

Funds that rely simply on Value at Risk models, better known in some quarters as "Voodoo at Risk," just won't make the cut. They will fail. Granted, there will be lucky months and quarters with great returns. But we have seen this all before in the oil squeeze of North Sea Brent by Transworld Oil and its $500 million loss, the stacking and rolling strategy of MG and its $1.5 billion loss, and the quarterly gains and give backs by many other commodity houses and oil companies.

This is a true Darwinian game. This is survival of the energy fittest. Except for a handful of funds, they just can't stack up against the great oil trading companies like Vitol or BP and the investment banks, and since energy trading is a zero sum game, the wealth transference could be massive. Count on more great quarters for Morgan Stanley's and Goldman Sachs' commodity shops. The other investment banks such as Merrill Lynch, Barclays, Bank of America and Deutsche Bank are now playing catch up. In fact, Merrill Lynch has now been in and out of energy trading five times. Consistency and people make profits, not poorly executed trading strategies and opportunistic occurrences.

Summary

The positive value of the hedge funds is that they are bringing back liquidity and a risk-taking culture to the energy complex. Traditional energy companies such as the utilities are either exiting or being marginalized in this emerging, more sophisticated financial trading environment. The funds will also hire all those unemployed energy traders and they will re-center New York and London as the twin capitals of the energy trading world. On the downside, at least in the interim, many of the funds do not deeply understand energy dynamics. While they have sophisticated models and approaches to risk management, there is a dangerous hint of financial arrogance in the air. And we all recall what happened the last time that was there. Remember Enron!

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