Today's Energy & Environmental Hedge Funds

A number of specialised investment and financing vehicles have emerged in the energy and environmental markets. Some to replace old incumbents and others to take advantage of new markets and new investment opportunities.
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HEDGE FUNDS ARE not necessarily a new phenomena in energy markets, nor indeed are commodity traders in the form of Commodity Pool Operators (CPOs) or Commodity Trading Advisors (CTAs). Equity oriented energy hedge funds made money after the collapse of Enron shorting the merchant segment of the industry.

A number of very large commodity trading hedge funds also saw an opportunity to recruit talented and experienced energy traders from the collapsed merchant segment in the same time frame. However, there were just 10 or so hedge funds actively trading energy commodities a year and a half ago. Today, there are more than 110, with more in formation. In our universe of energy hedge funds, we have counted more than 400 hedge funds in the energy and environmental space, and we have been reliably informed from other hedge funds that we have under-counted. So what happened to create this influx of new hedge funds?

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Why Now?

In considering this question, there are a number of issues that bear consideration. Firstly, the universe of over 8,100 hedge funds has seen returns diminish considerably over the last 2-3 years as existing strategies become overcrowded. An average 8% return last year for hedge funds is not an adequate reward for the risks that investors take by placing their money with a fund. Meanwhile, those early energy-focused funds were returning between 40% and 100% to investors during the same period. While those types of returns are not sustainable for the longer-term, energy focused strategies provide an opportunity to make better than the average hedge fund returns.

A second reason is that there were many experienced and talented energy traders let go by the merchants and utilities. As the investment banks and hedge funds moved in, many of these skilled resources were snapped up while others some saw the opportunity to set up their own hedge funds to trade energy commodities. However, the energy trading talent pool isn't, and never was, very deep and already there is a shortage of good talent.

But the overwhelming reason for the rush to energy has been the supply/demand dynamics across energy commodities that have driven commodity prices ever higher. Similarly, volatilities have increased in energy commodities – and hedge funds like volatility. The bull run in commodities has resulted in higher profits for energy companies that produce energy and spilled over into other segments of the industry as activity levels have increased – creating an opportunity in equities as well. Additionally, restructuring across the industry as cash-strapped merchants sold off assets has created secondary debt, distressed assets and other investment plays across the industry in which hedge funds are now playing a role.

Burgeoning oil and other energy commodity prices have had an additional effect of focusing minds on energy efficiency. While current oil prices do not seem to have had much impact on economic growth rates and buyers' behaviour today, there is a realisation that efficiency programmes will be needed, as well as a renewed interest in other technologies that might provide alternative energy sources. This has also to be set against the growing consumer interest in all things environmental that has resulted in new regulations around emissions in particular. This has added burden, cost and complexity across the energy industry. The confluence of energy and environment is really just now beginning, but it too provides a wealth of opportunities for investors and hedge funds.

Types of Energy & Environmental Hedge Funds

We have built a new classification of hedge funds in the energy and environmental space simply because commonly used financially oriented terms to describe hedge fund strategies don't work too well when applied to energy. In the universe of over 400 funds that we track, there are many strategies at work.

Commodity Funds

Energy commodity funds trade all the energy commodities as well as energy-related commodities such as uranium, sugar and steel. Some commodity trading funds trade a variety of different commodities including metals, ags, softs, grains and so on but have a significant exposure to energy commodities in their portfolio. Some have been set up by ex-merchant traders or ex-investment banker energy traders and have a more focused energy commodity approach. We find that many are considering or already trading emissions too, particularly in Europe. Many of the energy commodity trading funds follow more fundamentally based strategies as opposed to the trend following strategies commonly used by CTAs.

This year, we have begun to see a number of issues arise with commodity trading strategies. Already, a small number of newer funds have exited the business as they discovered that their strategies were not paying off. In particular, these have been funds trading highly volatile electric power markets in the US or those that simply pursued a traditional merchant-type strategy without the help of the merchant company behind them i.e. owning physical assets such as generation assets.

Energy is a risky business and a commodity trading strategy is the most risky strategy as a result (particularly in trading financial energy in North America but also affecting oil and gas commodity markets as well). Energy commodity markets are behaving differently today, and there is no historical precedent for some of this behaviour. We argue that there is a structural change underway in energy markets and that as a result, history is no longer a predictor of the future.

Today, we are seeing the rapid *'financialization'* of energy trading. Electric and gas utilities (particularly in the US and some in Europe) are mostly exiting energy trading. Replacing them are both investment banks and hedge funds. Natural gas trading – which broke down after the demise of Enron and energy merchants – has taken three years to be re-established itself. Today, BP is the largest natural gas trader in North America. Similarly, new financial risks entail either ownership or access to physical assets in many cases. Financial trading, thus, has become re-established on both the established energy exchanges (NYMEX and IPE), and the deeper OTC markets through new participants. Today, this triangle of trading includes multinational oil and gas companies, investment banks and hedge funds, with electric and gas utilities increasingly marginalized in the North American markets.

Markets in Europe are a little different with large national oil, gas and power companies. The consequence is that hedge fund participation in the energy space has mostly been confined to the UK, Switzerland and Scandinavia. Scandinavian funds are almost all related to trading electric power derivatives in the fairly mature regional Nord Pool.

In Asia, there are a few energy specific hedge funds and some entrance by more established macro funds.

Equity Funds

There are now over 100 energy equity funds. Generally they have a long bias and track the entire energy complex by taking long and short positions in energy equities. The funds often diversify by seeking exposure to different segments in the industry such as exploration and production (E&P), Master Limited Partnerships (MLPs) or utilities as examples. Others diversify by seeking out early opportunities with private companies (pre-IPO) and helping those companies float on markets like the AIM in the UK.

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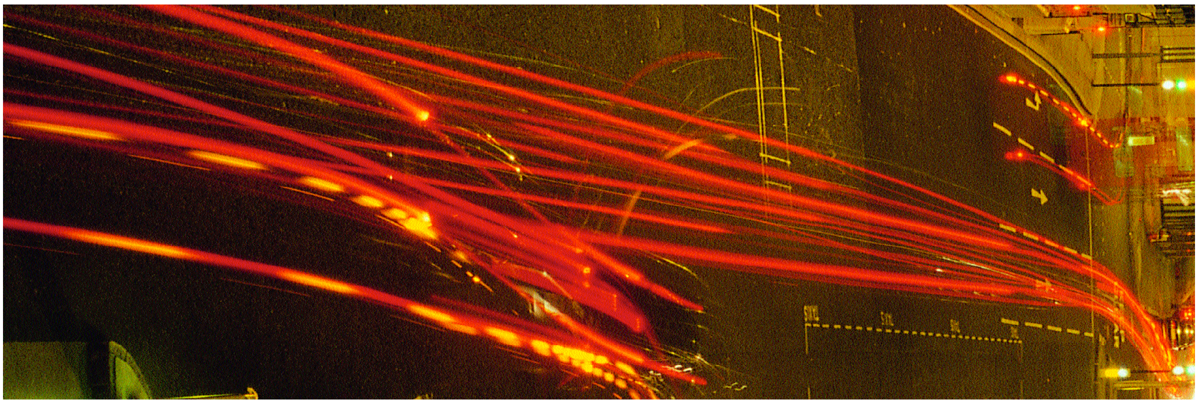
Recently, there has been a trend among newer energy equity funds to diversify their portfolios by seeking some exposure to energy commodities via exchange traded futures and options. Generally, these funds limited their commodity exposure to 20-10% of their portfolio and they are seeking 'arbitrage' between equities and commodities. Other funds, particularly those focused more on the E&P side of the business, may also seek to become owners of oil and gas reserves in the ground via acquisition of producing properties or by farming in to exploration activities.



This year, the equity-focused funds have, on average, performed better than the commodity funds. This, in part, is due to the behaviour of energy commodity markets in 2005 – as this behaviour has become dislocated from historical trends – and to the impact of greater profits and greater activity levels in the industry affecting the perceived value of energy and energy-related equities.

Not only have energy equities thrown off some good dividends but they have also appreciated considerably in 2005. Energy equities may still be under-valued in certain industry segments given the need for majors to replace reserves (via the acquisition of independents) and the anticipated M&A activity in the North American utilities segment after the repeal of the Public Utility Holding Company Act (PUHCA) which, until now, has thwarted large utility consolidation in the US. That will now change with adoption of the new US Energy Policy Act of 2005.

Debt, Distressed Assets & Other Infrastructure Strategies

The counterparty credit crisis that hit the industry after the collapse of the merchant sector has meant that assets have been sold off to provide cash to pay down debt. These assets run the entire gamut of the energy complex – from producing properties through gathering systems, gas plants, pipelines, generation etc. Hedge funds have seen opportunities in this arena too and are now one of the largest providers of debt financing to the old merchants.

The most obvious activity by hedge funds in this area has been in the MLP – a tax efficient structure created two decades ago by the US Government, primarily for the E&P sector. However, it has become one of the vehicles of choice for investment banks and hedge funds to purchase industry assets in the midstream as well as the upstream side of the business. The MLP structure allows funds to participate in debt financing in order for the MLP to purchase more assets and to convert that debt to equity in the form of units as the MLP is floated. By owning declining assets that throw off cash, the unit holders benefit from price appreciation and healthy earnings. We are also hearing talk of 'Green MLPs' for biomass plays in the green financial markets.

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Recently, a number of funds that are a hybrid of private equity and hedge fund in structure – where investors face an elongated lock up on their money – have been formed to focus on direct investment in the industry infrastructure. In part, the supply/demand dynamic in the industry today has been brought on by a lack of investment. Now that the obvious investors on the part of the merchants have gone, these funds see opportunities to finance capital projects related to infrastructure such as generation facilities, for example.

A fall out of this activity by hedge funds has also been the influence of the funds at board level. For example, hedge funds own a substantial piece of Aquila and have sought board level appointments. In the UK, hedge funds sought to block the restructuring of British Energy.

Alternative Energy

The number of environmental hedge funds is also growing substantially and we now see more than 20 funds in this space with more in formation. These funds are seeking – through a variety of strategies – to invest in and profit from emissions trading, carbon credits, investment in environmental companies equity and debt, investment in renewable energy schemes and trading the more established SOx (acid rain) and NOx (urban ozone) markets in the US.

So called 'green hedge funds' are taking a somewhat different tack than usual emerging markets in that the business model is changing to a hybrid venture capital/hedge fund strategy to lock down investment from 2-4 years and trade the monetized credits for projects. Some big macro hedge funds in New York like the illiquidity of the emerging environmental financial markets and see good arbitrage opportunities for emissions and renewable energy trading specifically. There are also a number of nascent exchanges for trading of emissions in both Europe and the US.

And most importantly, there is obvious cross commodity arbitrage for energy hedge funds trading oil, gas, power or coal. We continue to expect the green space to really heat up further as the EU ETS and Kyoto generate more interest in green trading over the next two years.

Fund of Funds

The most recent marker of ongoing investor interest in energy has been the emergence of funds of funds focused on energy and natural resources. We see more than 20 fund of funds with more in formation. A fund of funds is like a mutual fund of hedge funds. By investing with different hedge fund managers and running a portfolio of energy hedge funds, the fund of funds attempts to reduce risk and volatility but delivers slightly less return after fees. This approach is popular with both privately wealthy individuals, family offices and institutional investors such as pension funds. Additional benefits for investors are a lower minimum investment amount (perhaps US$ 25,000 as opposed to $100,000+ for single hedge funds) and the fund of funds ability to gain access to hedge funds that are closed to individual investors. In the latter case, many of the better known earlier energy hedge funds are now closed to investors.

Summary

While energy hedge funds have often been the scapegoat for the run on energy commodity prices, there is little evidence to support this. We estimate that the commodity funds control about US$ 50 billion in assets and with many of them focused on more fundamentally driven strategies, they have little impact on price formation. However, they do have an impact on intra-day volatility in the way they trade. What is often missed by the media is that energy hedge funds are endemic to the industry and pursue a wide variety of strategies that have no impact on commodity prices or price formation.

We expect to see hedge funds and other investment vehicles continue to enter the energy industry. After all, energy is in the news on a daily basis and the opportunities to make money in the complex are increasingly obvious as a result.

However, the issue for investors is, can these funds make money in a down-market too? ■

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