Energy Hedge Funds: Why Have They Appeared Now?

Hedge funds have been rumoured to be influencing energy prices for over a decade now but most of that was just market hype. This year, we have seen the real thing with the entrance of numerous hedge funds into energy commodity trading, report **PETER C. FUSARO** & **DR. GARY M. VASEY.**

UNREGULATED AND LARGELY secretive hedge funds trade crude oil, petroleum products, natural gas, physical and financial power, coal, emissions and renewable energy. They are also active in distressed generation and other energy industry physical assets and both equity and debt for energy companies. Some are even extending their platform into carbon trading. Seeing this activity, Global Change Associates and Utilipoint International collaborated on the first study of energy hedge funds as well as compiling the first global directory of these funds.

Why is Energy Attractive for Hedge Funds Now?

From our research, we have established that there are over two hundred known hedge funds active in the energy sector with many more in formation. To put this in some context, there are more than 8,100 hedge funds globally managing over US$1 trillion in assets today. Energy is still a relatively small but rapidly growing component of their universe. There are many factors responsible for this change in hedge fund strategy. For one thing, traditional equity returns this year have been flat so that many funds are not making the kinds of returns expected for this type of investment. Furthermore, many pension funds and other institutional money are now looking for safe harbour for higher yields through alternative investment strategies. There is a flood of new money coming into the hedge funds. The energy complex, meanwhile, has seen higher prices, rising volatility and greater trading volumes. That makes it attractive to the funds.

> There are more than 8,100 hedge funds globally managing over US$1 trillion in assets today <

The hedge funds however, are a double-edged sword for the energy markets. While they have provided some of the needed market liquidity that was lost through the demise of Enron and other energy merchants, they are also bringing greater intraday price volatility to oil and gas markets. Additionally, they are trend followers to a great degree, and they trade the Goldman Sachs Commodity Index with 'black box' models in that manner and so they tend be long the market. That's great as oil prices keep rallying. The question is do they head for the exits when prices fall? Only time will tell.

From our study research, we have seen a marked increase in both energy futures trading and OTC trading via NYMEX's Clearport trading platform. The oil markets have recently brought record trading volumes to NYMEX. The fundamental factors of oil supply tightness this year and next promise to bring even more volatility. These market fundamentals in the energy complex are increasing supply tightness in oil and gas production and refining capacity coupled with robust demand that will continue next year. So 2004 has been a prelude for what is to come.

Continued High Energy Prices in Prospect?

Next year's energy markets promise to actually be more volatile than ever before. One reason for this is the sustained lack of investment in the upstream productive capacity by OPEC over the past 20 years as well as a hesitancy by the oil majors to invest because they have been hurt by prior oil price collapses. This time they are reluctant to step up with new drilling programmes and instead have collected their rent cheques as prices continue to appreciate. They make money by maintaining a business-as-usual approach. Rather than using profits to expand exploration and production budgets, many have been returning money to shareholders through increased dividends and stock buy-backs. Expect more great quarters for the majors and a rise in their stock prices. Many securities analysts have been slow to grasp this fundamental change i.e. the lack of new investment except for some independent drillers who's activities are unlikely to do much to quench the increased demand. Led by the US and China once again, oil demand promises more of the same in 2005.

Due to these market driven factors, the funds are scaling up their oil trading operations; particularly in Europe and Asia as well in North America. In the US, the latest play by the investment banks and hedge funds is to buy physical oil and gas reserves in the ground. This action has not only pushed out the forward curve and created greater open interest in the back months on the NYMEX WTI contract, but also suggests that higher prices through 2010 are to be the order of the day. What our research has also demonstrated is that the hedge funds are now investing in the energy complex in growing numbers and with a longer-term viewpoint. They are, and always have been, involved in distressed asset securities – both debt and equity – but now increasingly seem to be taking a longer-term view with respect to these investments. This has been evidenced by the funds flexing their shareholder muscle at British Energy and in other situations. Buying oil and gas reserves in the ground is just part of a picture in which hedge funds are acquiring assets across the energy value chain in the upstream, midstream and downstream energy sectors.

The global oil markets have now reached a new plateau in oil prices. The majors have been slow to react to this phenomenon, but are now studying the longe -term price affects. Another factor that has brought hesitancy to stepping up oil and gas drilling by the majors is that other commodity prices have also increased this year which has ballooned their exploration and production budgets this year and next.

What is different this time in the energy complex is that the entire sector is benefiting by higher prices. We see higher prices in the upstream, downstream oil and gas markets but also a bull market in tankers, storage and every conceivable part of the energy supply chain. That has never happened before. Usually, when the upstream is making money, downstream refining is losing money. It wasn't so long ago (only two years) that refining margins were depressed. Today they are robust.

A multiplicity of factors can be seen in oil price formation. Today, exchanges like NYMEX and the International Petroleum Exchange (IPE) set the price of oil to a much greater degree than OPEC which has become the ultimate price taker. Oil prices are influenced by supply/demand fundamentals, weather, geopolitical factors, a terrorist premium, hedge fund and other speculative activity, to name a few. The fact is that higher intraday price movements will now be the order of the day and oil traders particularly will have to get used to this change.

> ... the data is only showing the tip of the iceberg in terms of the real presence of fund trading which will continue to grow <

Indicators of Fund Activity

Fund activity is indirectly reported to the US Commodity Futures Trading Commission through the *Commitment of Traders* report for crude oil, unleaded gasoline, heating oil and Henry Hub futures and basis swaps data for 'non-commercial' market participants on NYMEX. However, while the CFTC data shows futures and options positions on the NYMEX, it does not reflect the OTC energy markets at all. This is still where most oil and gas trading takes place. Futures dominate short-term trading while the OTC markets dominate the long-term energy markets. Moreover, a trader may be classified as a 'commercial' in some commodities and as a 'non-commercial' in others. It has shown a rise in 'non-commercial', indicating some of the funds presence, but quite frankly, funds also trade through banks. We therefore feel that the data is only showing the tip of the iceberg in terms of the real presence of fund trading which will continue to grow.

The relatively secretive and unregulated nature of the funds and their activities helps to cloud an assessment of their true level of activity. The CTFC and indications of OTC activities provided by NYMEX Clearport only hint at the true level of their activity. The identification of more than 200 hedge funds active in energy today through our research combined with a lemming-like tendency to follow each other into new investment opportunities and strategies shows that this is already an established trend. Indeed, early returns suggested for many of these funds from energy commodity trading have been spectacular (one fund that we know of has reported 240% returns to date in 2004) and only serve to attract other macro funds to bet some of their assets in energy markets as well.

Many of the existing macro funds pursue long/short commodity strategies taking bets in a variety of markets such as grain, softs, metals and energy. These funds tend to be larger and well established with significant assets under management. Many of them are increasing their exposures as the trend in energy prices is upward taking long positions. Some of the macro funds engage in playing the spread between commodity markets and equities going long energy commodities and short energy equities for example. While the amount of money coming into these funds is growing, they are also shifting their investment mix towards a heavier energy component.

Another indirect indicator of hedge fund activity is the formation of energy-specific hedge funds. Former energy traders from the merchant sector are now setting up hedge funds specifically to trade energy commodities. Although most are still relatively small in comparison to the macro, largely commodity-based, funds, the new energy hedge funds are actively trading physical energy as well as derivatives, using their prior experience in energy markets to attract investors. Many new energy-specific funds are in formation currently and range in size from US$1m to US$600m. In fact, traders with prior energy experience are now in great demand from the funds and investment banks attracting hefty salaries and bonuses.

What is readily apparent from all of this activity is that the fund community now sees the energy complex fundamentals trending to higher prices and that it offers them an attractive sector in which to inflate sagging returns for investors. It is this factor that leads us to believe that the funds are here to stay for the medium-term at least and to suggest that this is not a short-term phenomenon.

Conclusions

There is a school of thought that the funds will enter energy trading and leave. We don't believe it. The scale and momentum that is now underway is unprecedented and signals a structural change in energy trading itself. The new triangle of trading is energy hedge funds, investment banks and multinational oil companies who have the balance sheet, risk appetite and trading acumen to bring energy trading to the next level.

Today, we only trade US$2 trillion in notional value for all energy commodities for all structures compared to a physi-

PETER FUSARO is chairman of energy and environmental financial advisory Global Change Associates and **DR. GARY VASEY** is Vice President for Utilipoint, a leading energy and utility industry analysis and consulting firm. They have also created the first ever directory of energy hedge funds which is available to subscribe to at:
www.utilipoint.com

cal global energy market of US$ 4 trillion and a foreign exchange and government securities market of over US$190 trillion. Energy is still at the beginning of its market maturation process as commodities usually trade six to twenty times the physical underlying market. This indicates that the energy complex should be trading at least US$10 trillion per annum by 2010. Hedge funds will provide much of that trading liquidity but so also will the banks and the energy industry. The energy markets have now rebounded from the Enron debacle but have surprisingly been rebuilt with a stronger balance sheet and in quite rapid time. Watch out now as the best years of energy trading are set to come with higher energy prices, volatility and greater profits! ■