Contacting the Staff

Executive Editor
Senior Vice President,
News & Research
Kristin M. Fox
kfox@hedgeworld.com
(312) 692-1536

Managing Editor
Terrance Stanton
tstanton@hedgeworld.com
(312) 692-0948

Senior Reporter
Susan L. Barreto
sbarreto@hedgeworld.com
(312) 692-1538

Reporters
Chris Clair
cclair@hedgeworld.com
(312) 692-1551
Christopher Faille
cfaille@hedgeworld.com
(860) 741-8969

New York Bureau Chief
Chidem Kurdas
ckurdas@hedgeworld.com
(914) 921-7810

Associate Editor
Michelle Reilly
mreilly@hedgeworld.com
(312) 692-0948

Sales/Advertising
sales@hedgeworld.com
(914) 921-7800

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Lipper HedgeWorld
707 Westchester Ave., Suite L4
White Plains, NY 10604

Editorial offices:
53 W. Jackson Blvd., Suite 252
Chicago, IL 60604

World Wide Web address:
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Subscriptions, Reprints and Advertising
(914) 921-7800

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EXCLUSIVE

Is Emissions Trading the Next Hot Hedge Fund Strategy?

By Chidem Kurdas

NEW YORK—Pollution quotas created for the regulation of environmental plagues—including acid rain, urban smog and greenhouse gases—have given rise to a market that could in time rival the trading in major commodities.

Some large hedge funds are already on it. Tudor Investment Corp., Greenwich, Conn., is said to be looking at trading carbon allowances in Europe. People from Citadel Investment Group LLC, Chicago, recently attended a coal emissions trading conference.

Peter Fusaro, chairman of Energy Media Group, is an energy adviser with hedge fund clients. He knows some 12 funds that trade emissions rights and expects new entrants in New York, London and Switzerland.

Green hedge funds, he calls them, quipping: "Green, as in money."

From investors' standpoint, one problem is managers' lack of track record in trading such new instruments, especially if the fund is a startup. Experience in energy markets helps—someone who understands coal is better able to arbitrage emissions generated by coal burning.

Another potential competitive edge is knowing the polluting industries, such as utilities, that are the users of the allowances. Besides trading allowances and credits, some hedge funds are investing in long-term environmental projects by participating in private equity deals.

See Emissions page 10

Roye Joins Mutual Fund Firm

By Chris Clair

WASHINGTON—Paul Roye, former head of the Securities and Exchange Commission's Division of Investment Management, has taken a job as senior vice president at Capital Research & Management Co., the parent company of the American Funds mutual fund group, the nation's second-largest mutual fund complex.

According to a spokesperson, Mr. Roye will work on providing the funds with legal and compliance advice, although he will not be involved in an ongoing SEC and NASD probe of alleged payments American Funds made to brokers to recommend the firm's funds. The firm is fighting the charges.

Mr. Roye announced in February that he was leaving the SEC to pursue a job in the private sector. It had been expected he would take a job at a securities law firm, since he previously worked at Dechert LLP before joining the SEC.

CSFB/Tremont Hedge Fund Index & Sub-Index Net Performance

CSFB/TREMONT HEDGEFUND INDEX & SUB-INDEX NET PERFORMANCE
Calendar Year Ending March 31, 2005

	YTD	1-Mth	1-Yr	3-Yr	5-Yr	Std. Dev., Ann'd (%)	Sharpe Ratio (RF=T-Bill)	Correlation vs. S&P
CSFB/Tremont Hedge Fund Index	1.09	1.43	7.48	9.66	6.29	8.04	0.58	0.48
Convertible Arbitrage Index	-1.10	-0.31	-0.84	6.55	9.97	4.68	0.64	0.14
Dedicated Short Bias Index	10.59	3.40	3.50	-7.88	-0.87	17.59	-0.39	-0.76
Emerging Markets Index	4.52	3.35	13.08	15.41	9.25	16.82	0.17	0.48
Equity Market Neutral Index	1.38	1.02	6.24	7.43	8.83	2.98	1.29	0.39
Event Driven Index	1.79	1.59	12.99	11.57	10.25	5.76	0.91	0.56
Fixed Income Arbitrage Index	1.00	0.91	5.70	6.54	6.96	3.78	0.18	0.04
Global Macro Index	2.10	1.40	7.91	13.25	14.22	11.42	0.68	0.23
Long/Short Equity Index	1.18	2.03	8.76	9.79	2.77	10.48	0.55	0.59
Managed Futures Index	-5.32	0.08	-7.14	12.03	8.01	12.15	0.08	-0.18
TASS Fund of Funds Univ. Avg.	0.93	1.54	6.38	7.91	4.79	5.72	0.26	0.52

Market Indices	YTD	1-Mth	1-Yr	3-Yr	5-Yr	Std. Dev., Ann'd (%)	Sharpe Ratio*
S&P 500 DRI Index	-0.38	2.10	6.98	4.64	-0.98	15.07	0.35
MSCI $ World Index	0.63	3.01	10.11	6.92	-2.57	14.09	0.06
T Bill - 90 Day	0.41	0.21	1.65	1.39	2.58	0.50	-4.20
Russell 2000 Index	-2.69	1.61	8.28	10.55	1.85	19.07	0.19

*Annualized Standard Deviation, Sharpe Ratio and Correlation vs S&P are calculated from January 1994. Three and five year returns are annualized.

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Arbitrage Opportunities

In 1995 the U.S. Environmental Protection Agency issued the first emissions allowances.

Carbon dioxide, nitrous oxide, sulfur and renewable energy credits markets are now established, and others may be coming. For instance new rules proposed by the Bush administration are expected to lead to mercury trading.

There are a few futures contracts in emissions but most trade is bilateral. For investors, that raises another issue: the pricing of assets in these over-the-counter, illiquid markets. Illiquidity may be a source of returns but it is also a risk.

New allowances from the EPA are auctioned at the Chicago Board of Trade once a year in March. Prices tend to be volatile, creating trading opportunities. People trade allowances of different vintages. There are also regional markets; some states, like California, issue their own allowances.

Differences between countries' regulatory regimes are another source of trade ideas. With enforcement of the Kyoto Protocol beginning in February, industrial countries with the exception of the United States have agreed to limit greenhouse gas emissions. Prices of carbon allowances differ widely between the U.S. and Europe.

Mr. Fusaro predicts that the United States will introduce additional emission limits in a few years, even though the U.S. did not sign the Kyoto Protocol. One common trade has been to buy cheap carbon allowances and hold them. Prices are on the rise.

Sulfur trading volume is around US$8 billion to US$10 billion annually. Carbon trading is much less, at US$2 billion, but by one prediction may be up to US$10 billion this year. It is forecast to grow to US$100 billion by 2010.

Compared to US$1 trillion traded monthly in commodity futures and US$1.9 trillion traded daily in foreign exchange, those numbers do not sound like much. But green trading is just under way.