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Fanning the Flames

An influx of hedge funds is making energy markets more volatile than ever

By MATT CHAMBERS
October 16, 2006

Energy markets have always been volatile, with constant shifts in supply and demand -- or just the expectation of such shifts -- triggering price swings that have often caught investors by surprise. But now, participants say, an influx of hedge funds has made these markets even riskier.

Many of these funds are employing particularly aggressive trading strategies, moving in and out of the markets more quickly than more-established investors, and in the process often magnifying the intraday movement of prices. That leaves everyone in the markets more vulnerable to losses, and it isn't just big investors whose money is at risk.

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Hedge funds traditionally are the province of the wealthy, but their investors increasingly include pension funds, meaning that a portion of people's retirement money is on the line. And small investors are getting around the big minimum investment that hedge funds require by investing in so-called funds of funds, which pool the money of many small investors and then invest it in various funds.

Regulators have shown an interest in asserting greater control over hedge funds, which aren't subject to the same degree of oversight as other investment vehicles, like mutual funds. But the Securities and Exchange Commission recently was stymied by the courts in an attempt to impose reporting requirements on hedge funds, leaving the future of regulation of the industry uncertain.

The risk of investing in the volatile energy markets was starkly demonstrated last month, when Amaranth Advisors LLC, one of the country's biggest hedge funds, said it lost roughly $6 billion in about two weeks in the natural-gas market. And many market participants

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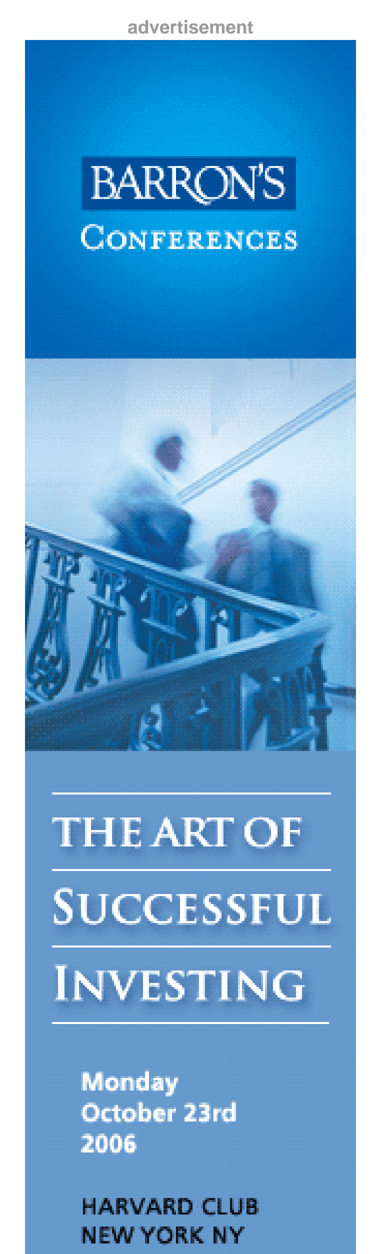

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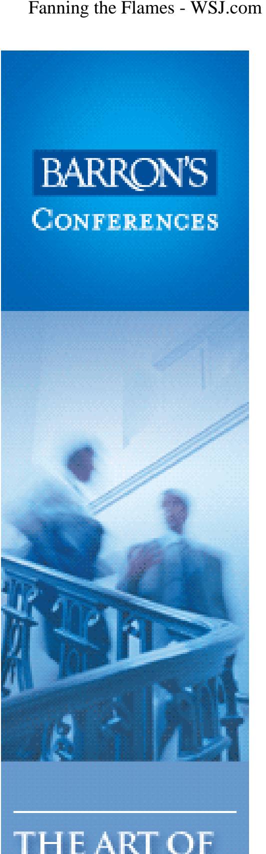

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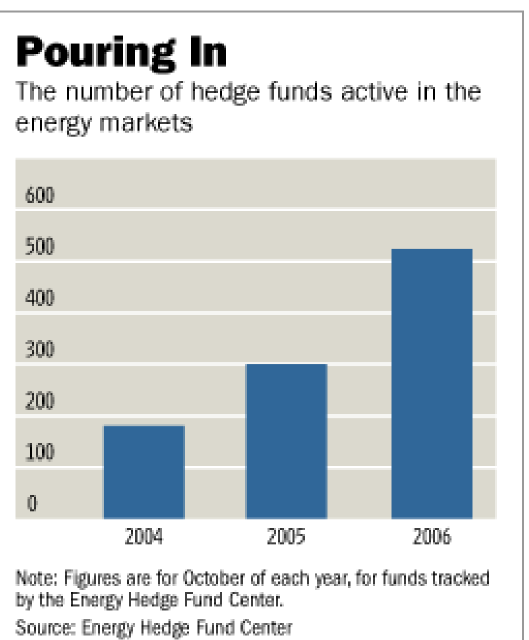
worry that there will be more stories like that.

'Risky Propositions'

"There's many more risky propositions than we've had before" among energy hedge funds because of aggressive trading strategies and inexperience in the markets, says Peter Fusaro, co-principal at the New York-based Energy Hedge Fund Center, which tracks fund performance. "We expect more blowups to come."

Hedge funds have boosted their numbers in the energy market to more than 500, from 180 at the end of 2004, according to figures monitored by the Energy Hedge Fund Center. The EHFC estimates the 525 funds it tracks have about $67 billion under management. Mr. Fusaro estimates that assets managed by energy hedge funds are growing at a rate of about 40% a year and that the total number of energy hedge funds could exceed 600.

Erk Hinrichsen, managing director of the hedge fund Energy Arbitrage Management, says the faster trading and proliferation of inexperienced traders that the flood of hedge funds has brought to the market are even more dangerous because of the overall increase in energy prices in recent years. For instance, a 1% drop in crude-oil prices is much bigger with prices above $60 a barrel, as they have been for most of the past year, than the same movement around $40 a barrel, where oil prices were two years ago. On top of that, hedge funds and other big investors in the energy futures markets, where bets are made on the direction prices will take, are often highly leveraged, which amplifies both gains and losses.



"The swings are so much bigger and many people haven't adjusted," Mr. Hinrichsen says. "They are still trading the same size of volumes, thereby increasing risk....You see people making a lot of money when they have it right, but when it goes wrong, you have extremes."

Amaranth Advisors isn't the only recent example of a hedge fund taking a notable beating in the energy

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markets. In August, New York hedge fund MotherRock LP told investors it was closing down because of heavy losses in the natural-gas market.

MotherRock, which at its peak managed about $430 million, has declined to comment publicly on whether it will be able to return any money to its investors. But one investor in the fund -- a fund of funds called RMF Investment Management, a unit of London-based Man Group PLC -- has told its own investors that MotherRock has informed RMF that it's unlikely to get anything back. And two other investors in MotherRock have issued statements saying they cut the value of their investments in the fund to zero.

MotherRock also has declined to comment on exactly how it incurred its losses. But the circumstances that some traders believe contributed to its demise -- and punished some other funds to a lesser extent -- demonstrate how unpredictable the energy markets can be. MotherRock is one of several funds thought to have bet on a decline in the price of the March natural-gas futures contract -- a benchmark for where natural-gas prices are expected to be next spring. That position apparently was based on a record oversupply of natural gas earlier this year, at the start of what was shaping up to be a fairly mild summer. But searing July temperatures across the U.S. led to unprecedented demand for natural gas, which powers many of the electricity generators that feed the nation's air conditioners. And that, in turn, caused a surge in the price of the March natural-gas contract, piling heavy losses on anyone who had bet the contract's price would fall.

Political Pressure?

MotherRock's losses pale next to those of Amaranth, whose setback was spectacular enough to refocus attention on the issue of whether regulators should monitor hedge funds more closely.

Some observers say the involvement of pension funds in Amaranth could steel lawmakers' resolve for further regulation, though the pension funds' exposure appears to have been limited and the extent of their losses isn't yet clear. For example, the $7.7 billion San Diego County Employees Retirement Association lost about $87 million through Amaranth, says Brian White, the association's chief executive. A spokeswoman for 3M Co. didn't offer an estimate of the company's losses from Amaranth, but says 3M's $9 billion pension fund had less than 1% of its assets invested in the hedge fund. Amaranth declined to comment on specific investors' losses.

The SEC, which monitors hedge funds for potential fraud, had sought to extend its oversight with a rule that took effect earlier this year requiring hedge funds to register with the agency and open their books to SEC inspections. But the U.S. Court of Appeals for the District of Columbia vacated the rule, and in August the SEC said it wouldn't appeal that ruling.

Soon after the Amaranth losses were revealed, SEC commissioner Paul Atkins said no new regulations on hedge funds were required because rules to prevent a widespread systematic failure in the market had worked. Another commissioner, Annette Nazareth, said the SEC's investigations into Amaranth would focus on whether or not investors were misled.

Still, pressure may be building for lawmakers to give the SEC greater powers, says Sol Waksman, president of Barclay Group, a Fairfield, Iowa, consulting firm that tracks hedge funds. "I think that there is a likelihood we will see additional regulation," Mr. Waksman says. "The politics of regulation in the environment we find ourselves is that it is more positive to voters."

Growing Appetite

Despite the losses at Amaranth and MotherRock and recent declines in energy prices, it appears that money will continue to pour into energy hedge funds, says Mr. Fusaro of the Energy Hedge Fund Center.

"The investment appetite is incredible, there's a tremendous amount of cash available" to these funds, Mr. Fusaro says. "Next year we're expecting to see a lot more trading in hedge funds by institutional investors," like pension funds and university endowments, he says, as more funds meet those investors' requirements for

a 12- to 18-month trading record.

Mr. Fusaro says investors in hedge funds would be well advised to look at the trading strategies of the funds they're considering, to ensure that they know their risks before investing and that the funds have a strategy in place to limit losses if the markets turn against them.

Mr. Hinrichsen of the Energy Arbitrage Management hedge fund says investors also should try to determine how much of their own money a hedge fund's traders have invested in the fund. "You want to see what the risk is for the individuals trading," he says, to ensure that they have some incentive to trade their way out of any losses rather than simply wind up the fund.

--Mr. Chambers is a reporter for Dow Jones Newswires in Jersey City, N.J.

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