Energy Hedge Funds: Short- or Long-term Minded?

by

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In recent times hedge funds have been accused of short-term opportunistic trading that hurts end consumers. This past June 26, House Speaker Nancy Pelosi – and over 20 other representatives -- accused hedge funds for partial responsibility for the rising commodity prices hurting American end consumers. Heated political debate resulted in the approval by a vote of 402 to 19 of a bill – H.R. 6377 Act—designed to strengthen powers of the Commodity Futures Trading Commission to help prevent market disturbances caused by commodities traders.

These politicians are mistaken in their over-generalization of the negative consequences of energy trading by hedge funds. In fact, many of the most successful energy hedge fund traders are long-term minded and actually promoting market efficiencies which benefit not only American but global consumers and industries over the long term.

Global energy investing is attractive as oil, gas, and other commodities hedge against inflation and currency depreciation. As global GDP growth is expected to slow from 5% in 2006 to 3.7% in 2008 according to the IMF, more investors are likely to be seeking opportunities to hedge with commodities. However, as sophisticated investors, hedge funds in the energy sector fundamentally understand that profits are earned over the long term and are less short-term driven than some believe.

According to Barclays, surprisingly only 80 hedge funds globally focus on energy out of a universe that exceeds 9,000. Of the six largest hedge funds, only one, D.E. Shaw, has a primary focus on energy, power, and commodities. In the case of oil, energy hedge funds are not materially impacting oil prices as some claim. Rather, these prices are rising for three main reasons: 1) the simple fact that world oil demand exceeds supply by 1.3 million barrels per day; 2) current global inventories are known to be low; and 3) substantial political risk exists in the Middle East and Nigeria.

Energy is a risky business and profit is uncertain. For all the vast fortunes made through energy, many have been lost as well. Successful energy hedge funds count years of knowledge and experience in their sub-areas of expertise which include traditional oil and production to energy technology and alternative energy. Some hedge funds focus on emerging markets or even more narrowly on energy in India or China. The successful energy hedge funds know what they are doing and do not take wild bets.

An example of one very successful energy hedge fund with specialized expertise is Eight Winds Partners. This fund, which returned over 79% in 2007, invests in high-tech energy-related projects: hybrid electric vehicles, nano-tech batteries, synthetic fuels, coal-to-liquids, thin-film photovoltaic, and electrochemical energy conversion devices. Passport Capital is another fund that

also benefited from energy-efficient technologies. This fund achieved returns in 2007 in excess of 60% by creating global portfolios with a long-term orientation investing in oil, alternative energy sources, and the development, manufacture, and promotion of energy-efficient technologies.
The most successful energy investors, like Eight Winds Partners and Passport Capital, are winning through deep industry knowledge and risk management expertise in specialized areas rather than short-term moves in the market. For instance, an investor in electricity needs to have specialized knowledge of structure of contracts and competitive legislation in a given jurisdiction. In the case of liquefied natural gas, an investor needs to understand government and market incentives that impact consumer market demand for natural gas versus other energy sources.

Finally, because energy trading is relatively new, asymmetry of information remains an issue. Hopefully, energy markets will continue to become more and more efficient over time. Lawmakers should focus on promoting efficiency and competition rather than strengthening bureaucratic powers. Perhaps Harry Browne, a past independent Presidential candidate, said it best: “The free market punishes irresponsibility. Government rewards it.”

Park Sutton Advisors is a leading authority on the financial services industry, and specializes in providing high-touch, confidential advisory services on small- and middle-market transactions. These include mergers and acquisitions, valuations, divestitures, strategic alliances, joint ventures, fairness opinions, and planning for equity transitions and successions.

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Steven leads and co-founded Park Sutton Advisors. He has focused on middle-market M&A and strategic advisory work in the financial services sector for the past 12 years working with asset and wealth managers, broker-dealers, and fund administrators globally.

Prior to co-founding Park Sutton, Steven worked with three investment banking boutiques where he focused on strategic and transactional work in the securities and investment advisory industry. He was a partner with Cambridge International Partners, which he joined from Millenium Associates where he led that firm's North American practice. Earlier, Steven worked at Putnam Lovell.

Steven holds a BA degree in Economics from Stanford University and an MBA in Finance from The Wharton School of the University of Pennsylvania. He is an alumnus of Stuyvesant High School. He is also a General Securities Principal.

Steven is a frequent speaker at industry conferences and seminars, and has been particularly active in the Speaker Retainer Program of the CFA Institute speaking on the topic of valuation of asset and wealth managers. He has served as an investment banking course instructor for Baruch College of the City University of New York. He is fluent in Spanish and prior to Wharton spent several years living in Mexico City.