Chapter 1

Introduction

Beginning is half the journey.
Traditional Korean proverb

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Why This Book?

When we launched our first hedge fund in 2006 we needed guidance. As a firm we had over three decades of experience in all facets of the energy industry as well as a background in management consulting and private equity. This rooted our approach in developing detailed business strategies and understanding the best practices for both young and mature businesses. What we did not have was an understanding of what it took to start and manage a hedge fund, especially a hedge fund focused on investing in energy and related commodities markets. As we looked for resources to help us fill our knowledge gap, we realized there was nothing out there.

Since those early days we have partnered with some of the best commodity traders and commodity investors to launch institutional quality asset managers. It has been a fascinating journey filled with a rollercoaster of events as varied as the 2008 Global Financial Crisis (GFC), the Bernard Madoff scandal, a day when we thought our investment bank clearers would go under, the end of Swiss banking secrecy, a deluge of new regulations, the exit of most banks from commodity trading, and a bunch of fantastic colleagues. We have also been blessed with great investors who we feel privileged to serve. Of course, along the way we have learned many lessons. Though some of these lessons came from success (or perhaps more accurately, serendipity), the majority of the lessons we have learned were the result of mistakes we made along the way.

As we reflected back on those days of perusing bookshelves for books to help us with launching our first hedge fund, we thought it might be worthwhile to distil some of the lessons that we had learned over the years and record them. We wanted to create the book that we wished we had when we started down this path.

It was a great idea. Unfortunately, like many projects of any worth, it took much longer than we had anticipated. Thankfully, after many years, we are grateful that we can finally present this book to you.

We do not pretend that this book is exhaustive. That said, we feel it will be a useful reference tool for hedge fund practitioners. Specifically both energy commodity hedge fund managers as well as investors in such hedge funds should find it particularly useful. At least that is our hope.

The Big Picture and Energy Commodities

The amount of capital invested in hedge funds is approaching USD 3 trillion. To put that in context, the amount of capital invested in hedge funds is greater than the individual nominal 2012 GDP of France (USD 2.6 trillion), the UK (USD 2.5 trillion), and Russia (USD 2 trillion). Even the combined nominal 2012 GDP of countries like Australia (USD 1.5 trillion) and South Korea (USD 1.1. trillion) does not equal the amount of capital invested in hedge funds. In fact, the USA, China, Japan, and Germany are the only countries that on an individual basis have a nominal 2012 GDP that surpasses the amount of capital invested in hedge funds. It is anticipated that more capital will flow to hedge funds, with total hedge fund assets under management to nearly double and hit USD 6 trillion by 2018.[1]

Undoubtedly, it is an interesting time to be involved in the alternative investments industry. From the end of World War II until the present day, we have seen the growth and institutionalization of corporate and national pensions, endowments, foundations, family offices, and other similar entities responsible for directing much of the approximately USD 3 trillion that is invested in hedge funds.

With the spectre of underfunded pension liabilities looming over many developed economies, alternative investments have emerged as a preferred asset class to help generate attractive, risk-adjusted returns that ideally have minimal correlation to traditional asset classes. Indeed, for many large pensions and other large pools of capital that are under liabilities pressure, ‘alternative investments’ have become an increasingly important part of portfolio construction.

[1]Citi Investor Services, *Opportunities and Challenges for Hedge Funds in the Coming Era of Optimization, Part 1: Changes Driven by the Investor Audience*, 2014.

Within this milieu, many investors in alternatives are looking to commodities and especially energy commodities to provide attractive, uncorrelated – if sometimes volatile – returns that form one component of a larger, diversified portfolio that likely includes both traditional and alternative investments. Oil has long been traded by hedge funds and other speculative capital pools. Electricity, the fuels for generating electricity, and so-called environmental products such as emissions credits and weather derivatives have become high-profile investment strategies offering the promise of potentially high uncorrelated returns.

These high returns, however, are accompanied by volatility and risk. Additionally, few investors have experience in evaluating these investment opportunities and few prospective hedge fund managers understand the market fundamentals and their associated risks. Many financial institutions and service providers have only begun to dedicate financial and intellectual capital to these rapidly growing investment strategies.

Case Study: Amaranth Advisors

For better or worse, the hedge fund that has become virtually synonymous with the volatility and risk related to energy commodities investing is Amaranth Advisors ('Amaranth'). Amaranth's spectacular demise in 2006, however, belied its more modest beginnings as a multi-strategy hedge fund launched in Greenwich, CT, in 2000 that was focused on convertible arbitrage opportunities. As convertible arbitrage opportunities and related profits began declining, Amaranth transitioned to an investment strategy that focused on energy commodities. Eventually, energy investing accounted for approximately 80% of Amaranth's profits, with its main fund growing to over USD 9 billion dollars by August 2006. Unfortunately, that would be the peak of Amaranth's success.

In 2004, about two years before its implosion, Amaranth hired a natural gas trader named Brian Hunter. Hunter had worked as a natural gas futures trader for both a pipeline company and then for Deutsche Bank before joining Amaranth. In 2005, Hunter was so instrumental in helping generate USD 1 billion of profits for Amaranth that it was expected his bonus might be as high as USD 100 million. Hunter's natural gas trading strategy focused on spread trades using natural gas futures. In this strategy, traders enter into long and short positions in the same underlying and benefit from the difference in pricing over time, or the *spread*. In addition to natural gas futures, Hunter overlaid call and put options on the underlying natural gas

future contracts as well as natural gas swap contracts that enhanced his core spread trade strategy using natural gas futures.

In early 2006, Hunter continued his spread trading strategy by buying natural gas futures contracts, options, and swaps for winter delivery, shorting non-winter-month gas futures, and entering similar positions via options and swaps. The maturity of these contracts ranged from 2006 until 2010. This strategy served Hunter and Amaranth well through the spring of 2006, when Amaranth's energy investments were up approximately USD 2 billion by April. In May, the long-dated natural gas future positions entered a period of volatility, although trouble was not immediately apparent.

After peaking at over USD 9 billion in August, Amaranth's main fund experienced a significant drawdown in September 2006 as the natural gas positions Hunter had taken started moving against him. By the middle of September, the fund had experienced a 50% drawdown and had a single day loss in September of USD 560 million. As the fund had difficulties meeting the ever-increasing size of margin calls, eventually market participants purchased large stakes of Amaranth's natural gas positions. The natural gas markets eventually stabilized towards the end of September 2006. Unfortunately, Amaranth's loss led to the closing of its doors and Amaranth and Hunter have been involved in a variety of regulatory investigations and legal actions since then. Amaranth, named after a flower meaning 'unfading' or 'eternal' in Greek, appears as though it will live up to its namesake, albeit for the wrong reasons.

Layout

With the hope of helping you launch a fund or invest in an energy commodities hedge fund that becomes an institutional quality asset manager and not another Amaranth, we have organized this book in a way that we think will allow it to be used as a reference guide as different issues or topics arise. Beyond this Introduction, comprising Part I, the book has four further parts and a series of appendices.

Part II provides the basics and background of hedge funds, energy commodities, and trading energy commodities. Part III delves into the key areas of starting a hedge fund with the focus on a sound business plan, the legal requirements of starting a hedge fund, and working with service providers such as prime brokers and administrators. Part IV focuses on the nuts and bolts of running an investment management firm by exploring topics of

fundraising and operations. Part V concludes with points that hedge fund investors should consider when adding an energy commodity hedge fund to their portfolio, as well as thoughts we have had on the future of energy commodity hedge funds. The appendices include outlines of a sample business plan, an offering memorandum (also referred to as a private placement memorandum or PPM), and a due diligence questionnaire.

The Beginning

We have come a long way since trying to figure out how to launch our first energy commodities hedge fund almost a decade ago. Like us, the alternative investments industry, and hedge funds in particular, have come a long way in the last few years. We hope the beginning of this journey for you ends up being as rewarding as it has been for us. It is an incredible time to be part of an exciting and dynamic industry. Although the hedge fund industry has matured considerably since Alfred Winslow Jones started the first hedge fund in 1949, perhaps a review of the past is the best place to begin your journey.

Bibliography

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