Investors Expect To Ramp Up Energy Hedge Fund Due Diligence

Institutional investors may begin looking at smaller energy hedge funds with strong risk management and industry experience after the blowup of **Amaranth Advisors**, several industry experts said.

"I think investors should look at smaller funds," said **Gary Vasey**, co-creator of **Energy Hedge Fund Center**.

And while others might not have been as straightforward regarding emerging hedge fund managers, others cited the size of Amaranth as a deterrent going forward for investors who previously focused on returns.

"Amaranth is, or at least was, a very successful fund that did very well by its investors … and when times are good and money is rolling in, I think investors will tend to turn a convenient blind eye to the amount of risk on the table," said **Stephen Schork**, editor of **The Schork Report**, an energy industry newsletter.

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> **Stephen Schork**
> *Editor*
> *The Schork Report*

Vasey said it is important that investors stop conducting due diligence based on a checklist that is not written for energy investing.

"Energy is very volatile, very risky and you need to have half-a-clue of what you are investing in," he said.

According to the Energy Hedge Fund Center, there are at least 525 energy-related hedge funds with $67.4 billion in assets under management.

Vasey said an investor needs to look at a fund manager's track record and industry experience and not the size of a firm when investing.

"If someone is making a billion dollars a month in the natural gas market...sooner or later…you know he is going to take a beating," he said.

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> *Co-Creator*
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"I would expect now, especially in light of **MotherRock**…and we've had some other implosions to a minor extent in the community over the last two years, I would like to think the internal risk controls at these firms would stand up and take a greater voice," Schork said.

Sampson Jordan, pension administrator for the **Austin (Texas) Police Retirement System**, said his plan discussed energy hedge funds in September and still sees opportunities in the commodities market, though his plan "will definitely be more diligent…it's not like it was two or three years ago when we first did energy. We definitely look at the dynamics of the industry."

Also, the **San Diego County Employees Retirement Association** has said it will review its entire hedge fund/portable alpha investment program at an educational workshop on Oct. 19 after losing approximately $85 million in Amaranth.

Other plans that were caught in the Amaranth failure touted their hedge fund structure as a sign of good risk controls. **The Pennsylvania State Employees Retirement System**, which had exposure in Amaranth through an investment with **Morgan Stanley Alternative Investment Partners**' fund-of-funds, said the impact of the Amaranth losses on the plan is likely be less than 0.1%.

"The fact that a potential loss of half of Amaranth's value would lower the Fund's performance by less than one-tenth of 1% is testimony to the value of the broad diversification inherent in our Fund of Hedge Funds program," the plan said in a statement.

Vasey said it is important to look at a fund's systems and risk management because a lot of energy commodities are far too volatile for normal risk metrics to have any kind of application.

"There is a lot of additional due diligence if you are looking at energy hedge funds, he said.

"Investors are going to be more demanding in knowing what kind of risk controls are in place," Schork said, adding that exchanges may become a selling feature for some funds.

Schork said the Amaranth blowup will be a boom to the exchanges.

He said if Amaranth's trading had been done through a regulated exchange, the firm would never have been allowed to trade at the exposure level it was at, which Schork said reached 10 times the amount allowed by the **New York Merchantile Exchange**.

"The big thing really to emphasize is quite simple, its just that energy is a different animal and if you don't know how the energy industry works, get some help and don't take a standard due diligence questionnaire off someone's Web site," he said.

Schork believes that funds with more diversification, limited exposure to natural gas and more exposure to crude oil and alternative fuels will be attractive to investors going forward.

As for where the next hedge fund blowup may come from, Schork says to pay attention to the gasoline market, where NYMEX is transitioning from its Reformulated Gasoline contract to a Reformulated Blendstock for Oxygenate Blending contract in January 2007—a move that could leave a fund stuck with the RFG contracts.