Analysts fear hedge fund losses in energy market tip of iceberg
Other large investors seen heavily exposed

SHAWN MCCARTHY

OTTAWA -- Analysts are predicting more financial carnage after one massive hedge fund told its investors that it is facing severe losses from enormous bets in the energy futures market, just a month after another fund went bust over its wagers in the same market.

"A lot of funds that jumped into the market have been going long on natural gas, and in some cases, extremely long," said Ben Smith, managing partner with First Enercast Financial in Denver.

"And it has not worked out for them."

By "going long," Mr. Smith means investors have been laying bets that prices will rise.
Amaranth Advisors LLC, a hedge fund with $9.5-billion (U.S.) in assets, warned its investors that the value of its two main funds fell nearly 50 per cent this month because of falling natural gas prices.

Its warning followed last month's collapse of MotherRock LP, a $400-million (U.S.) fund that blew up after gas prices fell 68 per cent from their peak last December.

Mr. Smith noted that a U.S. Senate committee report has estimated that $60-billion (U.S.) has flooded into the energy futures market in recent years, a trend that has lessened the influence of fundamental supply-and-demand issues and increased the role of speculation.

He said the number of energy hedge funds have expanded exponentially, adding that he knows bond traders who switched focus to ride the energy investment wave.

Many investors were betting that the wide gap between the price of crude oil and natural gas -- measured in equivalent British thermal units -- would narrow to a more traditional spread, meaning gas prices would climb.
But while crude oil prices fell from their peak of $79.92 a barrel in July, natural gas prices also weakened as the cool end to summer allowed users to fill up storage capacity in advance of the winter heating season.

Last week, natural gas futures briefly traded below $5 (U.S.) a million cubic feet, after peaking at nearly $15 last winter. In the same week of 2005, natural gas averaged $11.14 a million cubic feet.

A report on trading activity on the New York Mercantile Exchange indicates that non-commercial investors -- those who have no underlying need for the commodity -- were major sellers of crude oil futures in August and early September. While they increased their short positions -- essentially a bet that crude prices will fall further -- they also invested heavily in natural gas, both in long positions and in shorts, though more aggressively on the bet prices would climb.

In a hedge fund report released yesterday, analysts with Merrill Lynch & Co. Ltd. said the large investors remain heavily exposed to further drops in crude oil and natural gas prices.

"Despite the carnage in the energy market, large speculators did not panic and liquidate," wrote Merrill Lynch analyst Mary Ann Bartels.

And those investors added to their net long position in natural gas, despite price weakness.

In both cases, Ms. Bartels suggested their optimism is misplaced, and she forecast further weakness in prices.

John Kilduff, an analyst with Fimat USA, said he expects more hedge funds and other institutions to report major losses in the energy market.

"It's a zero sum game -- there are winners and losers. And we've all been waiting for the other shoe to drop in terms of who might have gotten hurt," Mr. Kilduff said.

But the Fimat analyst said pension funds and other institutions have been using energy investments as a hedge against their exposure in the equities markets, which were lacklustre when energy prices were climbing but
have rallied on the drop in crude oil and natural gas prices.

"Institutions see energy and commodities as being inversely correlative to equities markets. It is working for them, to a relative degree, at least right now."

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