

ELECTRICITY, WATER & WEATHER RELATED INVESTING

“... cause for pause ...”

Would you say investing in electricity, water and weather is still considered “exotic”? Why or why not

I would say that investments in these markets are still considered “exotic” for the great majority of investors. It is not, of course, that the underlying physical manifestation of any of these markets is exotic - in fact, they are all quite ordinary. It is that the financial and derivative instruments created and used to trade various facets of them have not historically been widely followed. It is a bit of a Catch-22, in that markets like these tend to be bucketed in the realm of “exotic” because they don’t fall within a more traditional sector categorisation (such as agriculture, metals, energy, etc.); which further elongates the maturity cycle of these markets. If you don’t fit within someone’s pre-defined list of buckets, they aren’t always willing to take the time to figure out what you do. To some extent, this is also a function of market size.

I think investors have come to recognise the potential and that there are opportunities in water, weather and electricity related investments. But a lot are getting the whole long-only talking head version that we see in the media. It is quite one-sided and sensational, and for serious, professional investors, this type of euphoria is always cause for pause. In fact, the latter are waiting for the downside to materialise to really understand the risks and how they are not always linked to the fundamental story of a particular market.

Why did you choose to invest in these markets?

Our research in the commodity and natural resource space strongly suggests that diversification among as many niche and specialty strategies has the ability to dramatically improve one’s risk-adjusted performance. Combine that with the fact that, generally, opportunities outside the mainstream markets can be those with a better or more asymmetric reward/risk profile and you have the makings for a portfolio that bundles a variety of higher volatility alpha opportunities into a return stream that can be attractive on a risk/return basis. The reality is that not everyone can focus on these types of markets because they are so different and eccentric, but for those who can there is an opportunity.

Isn’t everybody chasing the same names...?

Certainly this is true to some extent, but what tends to happen is you develop a “have- and have-not” scenario play out. One or two players will get majority of the attention - maybe they have a great marketing staff or just serendipitously become the “go-to” for that particular market segment. Asset flows follow and then you have “me-too” type investors piling into that particular manager. That does not always mean that the manager is the best trader or portfolio manager. If you can vet the space thoroughly and not always be concerned with having the “name brand” in your portfolio, or have the risk monitoring capabilities in place to handle smaller managers that are not on the institutional radar, then you can uncover some of these great hidden talents.

What are the different investment vehicles available to investors interested in this space?

Our focus here has been on the active managers, whether they are traders who are directly involved with the futures markets or those that access securities via markets and companies engaged in the space. There are other options, like ETFs for the water universe, but these are basically a long-only play that provides beta to a long term story. This is acceptable if your investment horizon is long and you are able to cope with some pretty sizable volatility in the short-term. But a closer look at these markets suggests that one of their most attractive features is their short-term volatility and the trading opportunities this presents. Many of the investment opportunities arise

from the less liquid side of the investment opportunity set - through private equity or venture capital deals. Although it is an option that probably masks some of the short term volatility, it none the less can be thought of as a beta play. Then you also have a fund like ours, that attempts to bundle a wide variety of these markets into a comprehensive resource-based fund structure that attempts to capitalize on the long- and shorter- term opportunities.

What are the risks in each case, and are the rewards commensurate?

One of the largest risks you have in these markets is the “newness” of them and trying to anticipate how different market participants are going to respond to any variety of different fundamental scenarios. You don’t necessarily have a long history of commercial participants that you can look at, to understand how they have responded historically. It is far more a realm of the speculators, and market psychology is going to drive prices in a way that may be very difficult to anticipate, or even react to. A case in point is what happened with the emissions markets last year; prices dropped about 70% in the early stages of trading.

This year, it will be interesting to see how the uranium market responds to the introduction of uranium futures trading. Now that there is a two-way market; what does it imply for all the bulls that have been chasing the uranium story for the last four years? You also have regulation issues in terms of governments stepping in and disrupting the markets.

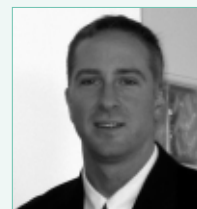
I think the rewards are there, but only for those who have the ability to navigate and not just assume market risk because of what might be happening in China in 2015. On the one hand you need to have the expertise to understand, focus and follow these markets. Whilst on the other, it is imperative to be able to trade in order to react to the changes. Otherwise it is more like a big bet on the commodity bull story. Some of the commodity prognosticators are well known for saying that commodity prices can never go to zero. That may be true, but in 2006 natural gas was down more than 70%. That is close enough to 100% for me to know I don’t want to be just riding out market beta. More over, that was in a “non exotic” market - let alone, in something, that is far more esoteric with a lot less players.

What are the peculiarities of investing in these markets as opposed to investing in traditional markets?

As discussed about risk, these markets don’t always have a historical data set to mine from in terms of the commercial participants. That is additional risk on the speculative side. You also have a limited talent pool - ie few people have been following a particular or these specific markets for a long time and understand its nuances. Or you may have someone who has been involved in the water industry for 20 years, but in a non-investment capacity. So one could be a water specialist but can they manage a portfolio? Can they assess risk and trade and structure investment activities with a realistic reward/risk ratio?

To/for whom are such investments suited and the benefits they can hope to accrue?

I would think that anyone who is a “professional investor” would be equipped to, ultimately, understand that opportunities that exist in these markets. You don’t have to necessarily understand the market microstructure of emissions trading on a day-to-day basis to get that exposure; there are managers who can take on that facet of the task. But you should have an understanding of what that manager’s view and trading style is, how they are managing risk, and how they are responding to the market dynamics.



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