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CAPITAL MANAGEMENT
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"When you look at a commodities market you need hedgers and speculators. If you don't have one, you don't have a market. That's how it works."
— T. Boone Pickens

Commodity markets are booming, volatility is back and demand for hedging and risk transfer is rapidly expanding. The opportunity for those firms able to monetize this explosive growth is incredible. While recent movements in the equity markets and rates have been relatively muted, commodity markets are seeing some of the biggest moves in a generation.

At the same time, many banks—the traditional beneficiaries of managing hedging demand—are publicly exiting their commodities businesses. Their departure creates an opportunity to fill the void and blows open the door to a lucrative alpha that was previously unattainable. This alpha is liquid, exchange traded, marked to market, transparent and electronically accessed.

What is this alpha?

Exchange-traded options and futures on metals, energy, agriculture, soft commodities, equity indices, rates and FX allow investors to transfer risk to others. Providing liquidity and carrying inventory sourced from *bona fide* hedgers is one reason markets exist. One participant "pays" another to take on risk he does not want. It is one of the oldest, most traditional and consistent sources of alpha.

Currently many long/short managers are suffering as momentum stocks crater and correlations breakdown. This trend could continue. The Russell 2000 index, which is a proxy for momentum, is reflecting increased hedging activity in the pricing of options. Many equity managers are trading Russell options, both calls and puts, in order to manage risk and hedge.

Hedging demand in numerous commodity markets is also exploding. Grains and metals are moving in response to events in Ukraine and Russia. Coffee is up over 80% year-to-date due to drought and disease across Central and South America. Options prices and implied volatilities are the highest we have witnessed in years in coffee (see figure 1).

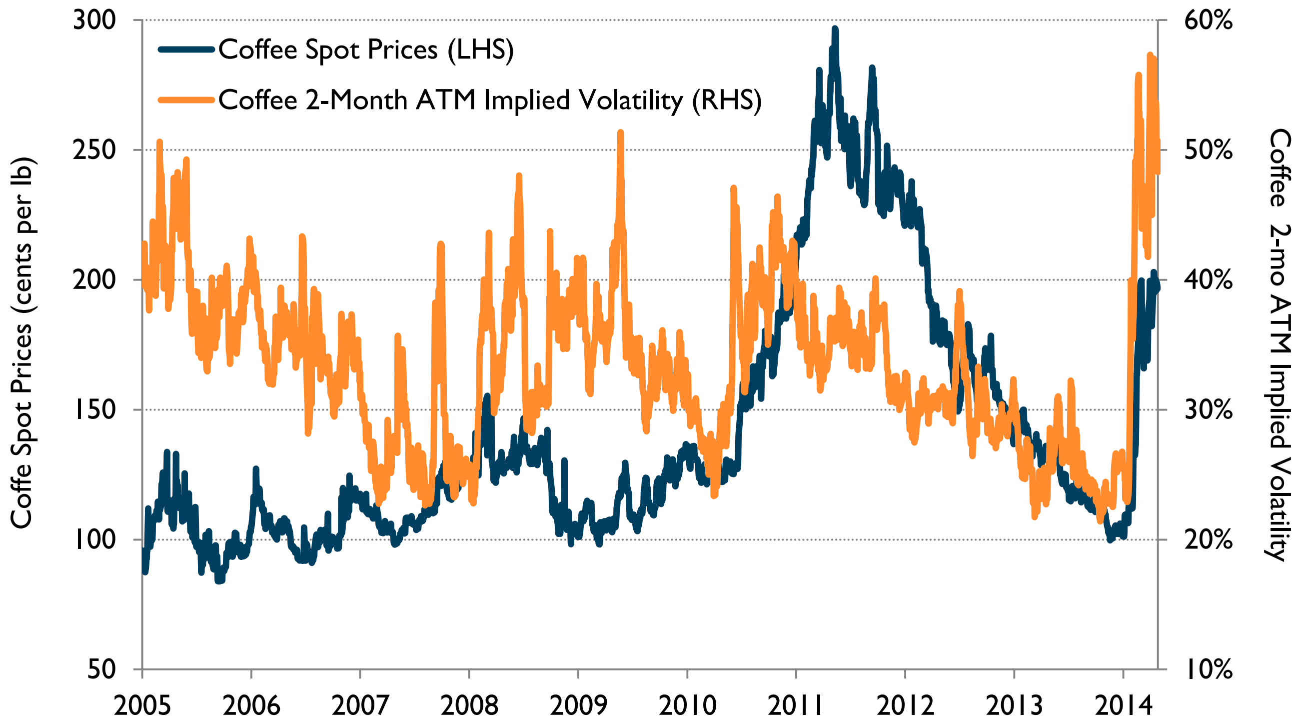

Figure 1: Historical daily coffee spot prices and 2-month at-the-money implied volatility.

TRADITIONAL ALTS BENCHMARKS	YTD Returns
S&P 500 Total Return Index	+1.89%
HFRX Global Hedge Fund Index	+0.38%
HFRX Hedged Equity Index	-0.19%
HFRX Relative Value	+0.78%
HFRX Emerging Markets	-2.38%
HFRX Equity Market Neutral	+2.65%
Barclay Hedge Fund Index	+1.21%
Barclay Fund of Funds Index	-0.22%
Barclay Global Macro Index	-2.10%
Barclay Merger Arbitrage Index	+1.73%
S&P Global Property Index	+5.62%
S&P Listed Private Equity Index	-2.09%

COMMODITY INDICES	YTD Returns
S&P GSCI (All Commodity)	+3.46%
S&P GSCI Crude Oil	+2.97%
S&P GSCI Natural Gas	+20.18%
S&P GSCI Agriculture	+16.72%
S&P GSCI Corn	+15.47%
S&P GSCI Soybeans	+16.36%
S&P GSCI Coffee	+78.67%
S&P GSCI Livestock	+14.11%
S&P GSCI Lean Hogs	+26.05%
S&P GSCI Softs	+15.77%
S&P GSCI Grains	+17.06%
S&P GSCI Gold	+8.31%

Figure 2: Returns from S&P Dow Jones Indices, Hedge Fund Research and Barclay Hedge. Year-to-date (YTD) returns are through April 30 if data source reports monthly returns and through May 2 if source reports daily returns.

In addition to the recent positive performance across commodity markets, the correlation between commodities and equities has fallen significantly over the last few years. As commodities are once again viewed as an uncorrelated asset, investment advisors and asset managers will increase allocations to the space. The newfound participation in the commodity markets will generate further demand for transferring risk.

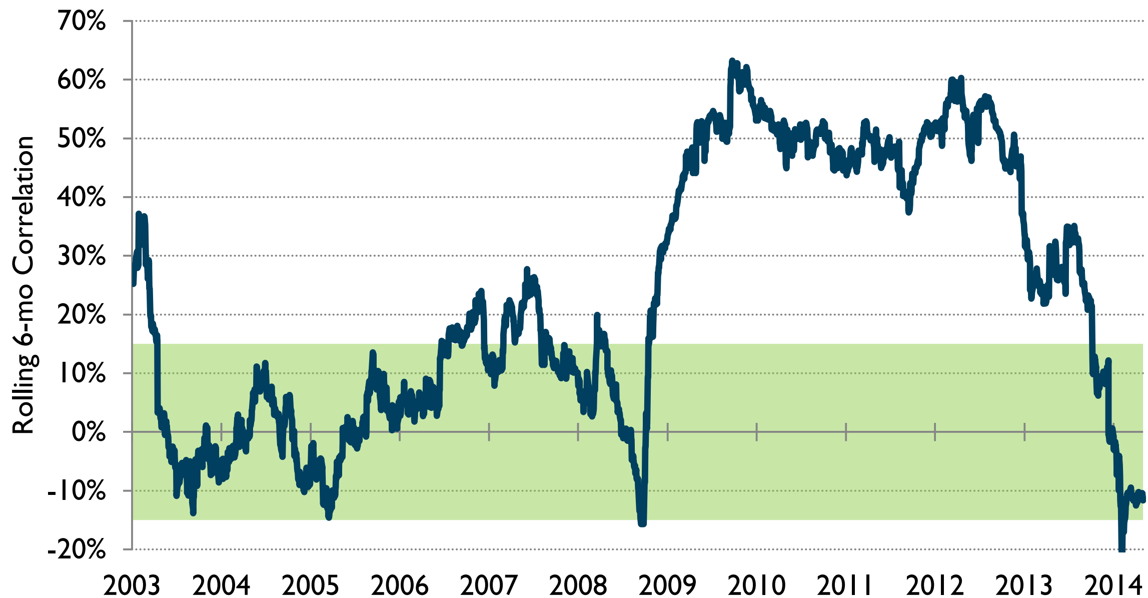

Figure 3: Six-month rolling correlation between an equally-weighted basket of commodities (energy, metal, grains, livestock and softs) and the S&P 500.

All of the activity, regardless if driven by geopolitical risks, monetary policy, over-valued equity prices or even odd weather patterns, is creating increased demand for hedging activity across multiple asset classes in the face of reduced supply.

There are other important structural shifts taking place that are drastically changing the industry and creating opportunity for sophisticated investors. Beyond the supply constraints caused by banks retrenching, access continues to become more automated and electronic. This absolutely creates a higher barrier to entry for many firms seeking to monetize this alpha.

One untold story behind the recent debate about high frequency trading is that irrespective of the strategy, asset class or opinion on the matter, advanced technology is a fundamental requirement just to compete and maintain an edge in the rapidly evolving electronic marketplace.

All of these factors indicate there is a liquidity void that exists in the marketplace. In the absence of the banks, the market requires billions of dollars of ready and willing capital to provide liquidity to the growing number of hedgers and speculators in the markets. This theme should continue for years.

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