

A Thought Piece from Commodity Talent LLC, an executive search firm focused on commodity specialists

Wall Street Commodity Wizards Turned Drops Into Gold in 2008 -- But Can They Repeat Their Magic This Year?

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(New York, January, 2009) -- For commodity trading, the year 2008 ended with a conundrum: Prices plummeted from records set midyear in the fastest drop in five decades, but, *abracadabra!* **Morgan Stanley, Merrill, Citigroup, JPMorgan, Barclays, Deutschebank** -- the lion's share of Wall Street's commodity units -- racked up best results ever. And commodities powerhouse **Goldman Sachs** neared its record, too.

A neat trick... and just how did the prestidigitators of petroleum, magicians of metals, pull it off? And can they pull the rabbit out of the hat again this year?

Of more immediate concern, especially in the trenches, are bonuses for 2008 and this year: Will the soothsayers of soy and sugar get paid for divining the right paths in 2008? Or do their overseer corporate chieftains have a bonus disappearing act of their own up their cuff-linked sleeves? And what about this year?

Interlocking answers lie in the unfolding economic tsunami that swept the world in the second half of the year, according to interviews with commodities executives, trading desk heads, sales and origination chiefs and portfolio managers at the Wall Street firms, hedge funds, energy merchant banks and private equity shops, as well as published accounts.

A leading cause of the record results was shrinkage of the trading community: Oil, copper and other commodity prices fell fast, but the capacity of financial firms to trade commodities fell faster. The last traders standing were in an enviable position, at least in the short run: People who needed to trade had to come to them.

"Forty percent of the competition has gone away but demand has dropped by only 20 percent," the global commodities head of a major international bank told Commodity Talent LLC.

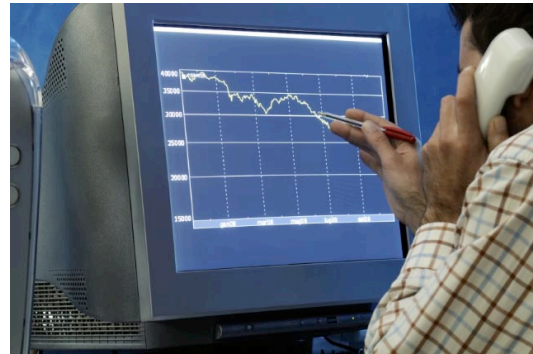
Wall Street Commodity Casualty List

Legendary Wall Street firms that came apart or stumbled in 2008 dragged down commodities units with them.

Lehman, Bear Stearns and Fortis, all with sizeable commodities divisions, disintegrated. The two largest Swiss banks, which reported large losses on mortgage-related securities, both clamped down on commodities: **UBS** exited direct commodities trading except for precious metals. **Credit Suisse** chopped emissions and power trading to get out of illiquid markets. **Bank of America** completed its shotgun marriage with **Merrill** at the end of the year with the securities firm's powerful commodities unit taking charge of the nation's largest bank's smaller group. **Societe Generale's** first-tier commodities unit has been regrouping most of the year ever since the French bank discovered it lost multiple billions of dollars in unauthorized non-commodity trading. **Sempra** commodities got squeezed with credit limits shortly after forming a joint venture with **RBS**, which stumbled and then had to take a massive capital infusion from the U.K. government.

But there is more to the story than counting survivors in a circular firing squad.

It wasn't hard to make money trading commodities in the first half as Nymex oil soared to a record \$147.21 and Comex copper climbed to \$4.2605 a pound, the highest ever. Corn, wheat and soy also hit highs. Institutional investors, hungry for commodity returns that beat the S&P500 the previous five years, poured money into the sector -- \$240 billion at the peak -- sending prices sky-high and adding to profits at the banks.



Banks Profit as Investors Exit

But those same institutional investors, particularly multistrategy hedge funds, began closing out profitable long commodity positions in mid-year, starting with oil, to raise cash to offset declines in stocks as the S&P500 lost 13 percent. As credit spreads widened, the decline moved to other commodities and then to positions that weren't profitable. In agricultural commodities, fund buying that boosted corn, wheat and soy virtually vanished.

The pain reached **Ospraie**, once the largest commodities hedge fund, whose flagship lost 27 percent in August, extending year-to-date losses in the fund to 39 percent. Founder and chief trader **Dwight Anderson** shut down the fund in early September and now is soldiering on with a private equity fund and an emerging managers platform as the firm struggles to regroup.

To this picture, add in the credit freeze that took hold at the end of the third quarter. That squeezed leveraged commodity positions as they rolled over and a rush for the exits began as huge redemptions tore through cash.

Desperation to get out of positions gave banks making the trades the advantage in commanding large bid-ask spreads, particularly for illiquid

markets such as power, freight and basis trading of many commodities.

Late in the year, commodities took a hit at another hedge fund giant. **Ken Griffin's Citadel**, which limited investor redemptions as its main funds fell about 53 percent in 2008, exited power trading.

Investors Rushed In as Prices Rose, They Rushed Out as Credit Froze

The size of the investor exit was huge: Barclays Capital estimated that commodity investments dropped 47 percent from a high in the second quarter to \$144 billion near the end of the year. The decline in raw materials investment matched an overall drop in hedge funds of every shape and size, with Morgan Stanley estimating a 45 percent fall because of losses and withdrawals from a high of \$1.9 trillion reached in June.

Banks had another way to make money as prices slid, apart from harvesting rich spreads. Correctly reading the bear market made for huge profits, even as corporate dictates reduced credit limits and imposed more stringent risk management.

"There was so much money to be made on the downside, you could make up for earlier losses," one veteran oil trader at a top Wall Street bank said. "This was not a time to fight the trend." A portfolio manager of a well-known multi-billion hedge fund said he hadn't done that well until he figured out the bear market in September and then ended the year up 18 percent.

Banks Too Big to Fail Got New Business as Credit Froze

A side effect to the credit crunch was a boost for commodity trading at

large banks, those deemed too big to fail-- Citigroup, JPMorgan, Bank of America and Wachovia (acquired by Wells Fargo) – whose balance sheets are seen as backed by the U.S. government. That made them perceived as less shaky counterparties in transactions than the traditional Wall Street commodity leaders, Goldman and Morgan Stanley.

Citigroup, for one, has seen clients who routinely used to give all their commodity trading to Goldman and Morgan Stanley come its way in the second half of 2008. Corporate clients and institutional investors now are allocating a portion of trades to the bank, citing the need to have a strong balance sheet available for credit issuance, as well as a desire to spread risk among a larger set of counterparties. And Merrill has been told by commodity clients that they will be more apt to steer trading its



way after the acquisition by Bank of America.

Some Hedge Funds Got the Bear

If some commodity hedge funds, just as some Wall Street commodity units, faltered in 2008, others figured out how to make money as prices rose and then tumbled.

Paul Touradji's New York-based flagship commodity-oriented fund Global Resources made a profit of 10

percent through November. **BlueGold**, a \$1.1 billion London-based hedge fund run by Vitol alumnus **Pierre Andurand**, turned in a 209 percent return between inception in February and the end of the year with long oil positions in the first half and short positions in the second.

Clive Capital, a \$3 billion London-based fund run by **Chris Levett**, returned 44 percent in the first 11 months of 2008. **NuWave**, a \$500 million New York-based fund managed by **Stuart Flerlage**, ran short commodity positions in the second half and rose 51 percent through the middle of December.

Merchant Commodity, a \$1.7 billion Singapore-based fund operated by former Cargill alumni **Michael Coleman** and **Doug King** rose almost 23 percent this year. **Krom River**, a commodity fund with \$810 million under management, returned more than 36 percent in the first 11 months. **Trafigura's Galena** subsidiary's metals fund with about \$500 million under management, hit 22 percent this year.

Commodity Bonuses Crushed by Losses Elsewhere, Taxpayer Bailouts

If commodity traders thought they might get bonuses of 9 to 11 percent of their profits, with most of it in cash – the rule of thumb in prior years – and if they thought good results meant no layoffs, they are having a rude awakening.

The range for 2008 bonuses is 2.5 – 5 percent of profits, with a lot in restricted stock that in many cases is subject to a clawback under adverse circumstances. At Merrill, the average bonus is down 50 percent or more. Top performers are getting chopped 20 to 30



percent, good but not great are subject to cuts of 50 to 60 percent and a fair number aren't getting any bonus at all. At Citigroup and Morgan Stanley, it's much the same. A Goldman commodities trader with a profit of about \$45 million would have gotten a bonus of \$5 million for 2007 but is getting only a bit more than \$2 million for 2008.

And while commodity units that hit records or near-records for the year are largely being spared massive layoffs, they, too, are being required to let people go by their C-level masters. At Goldman, a trader with prop trading profits of \$8 million was let go. Credit Suisse eliminated its emissions trading group and reduced head count in power trading as part of a general move to get out of lightly traded markets that might seize up.

Pressure on Bonuses May Lead to Exits from Financial Services

Pressure for lower bonuses will remain, particularly for banks and securities firms who got bailout money from governments, as officials ask for more and more details about pay in the glare of congressional hearings and investigations. The reduction in trading units as well as investor exits from commodities is making it harder to jump ship, a time-honored Wall Street way of showing dissatisfaction with a bonus. And leaving to start a fund from scratch, another popular method of thumbing one's nose at superiors, some are finding, is taking longer than planned.

"Trying to raise money in this environment is like trying to sell snowballs to Eskimos," said one veteran oil trader who left a top trading house in mid-2008 to start his own hedge fund. Another trader, who posted profits of \$200 million for two years running on multi-commodity trades at a major firm, found European backers pulling back from start-up capital placements. They cited the need to use the cash to shore up real estate investments.

The drought may lead some to consider careers at energy, mining and agriculture companies, where the compensation is a fraction of the scale on Wall Street. But work less prone to layoffs and a less frenetic lifestyle may have new appeal in the current climate.

Citigroup, Deutschebank, JPMorgan, Millennium, Clive Boost Commodities

That said, Citigroup, Deutschebank, JPMorgan, private equity giant **Apollo** and a smattering of hedge funds are expanding in commodities. And commodities units at **BNP Paribas**,

Calyon and **Bank of Montreal** are finding talent coming their way they never had access to before 2008.

JPMorgan has been the most acquisitive of the Wall Street banks. It took on board the well-regarded Bear Stearns Houston-based energy commodities unit, with about 200 staff, almost doubling its staff, as part of a Fed-forced takeover of the smallest Wall Street investment bank in March. Bear Energy head **Paul Posoli**, an Enron and Calpine alumnus, was named co-head of global energy. In December, JPM continued its buying spree, acquiring from UBS the Swiss bank's global agricultural trading as well as valued energy operations in Canada, which supplies U.S. markets with ramping up oil and gas production from provinces on both sides of the continent.

Morgan Stanley's net revenue in commodities topped \$3 billion in the firm's best year, about par with Goldman. The year also saw a changing



of the guard. Commodities Chairman **Neal Shear** and Commodities Head **John Shapiro**, the longest running successful commodities partnership on Wall Street, departed, along with its long-term Global Oils Trading Head, **Olav Refvik**, dubbed "King of New York Harbor" for early prowess in trading oil and storage in the

metropolitan area. Morgan Stanley's new chiefs are Co-Heads **Simon Greenshields** and **Colin Bryce**, with **Goran Trapp** running the global oils book.

Morgan Stanley's Neal Shear Forms Commodities Unit at Apollo

Shear went to Apollo to start commodities trading in tandem with private equity investing. Shapiro and Refvik are in discussions to evaluate opportunities.

Citigroup, where **John Casaudoumeq** is Global Commodities Head and **Stuart Staley** is Deputy Global Head, also posted a record year, topping \$400 million. The bank continues an expansion path despite a corporate pledge of cutting staff by 52,000, or one in seven globally. The commodities division, which hired a group of Merrill's metals traders last year and acquired part of the Credit Suisse power book, is on track to reach \$1 billion in net revenue in two years. The unit, which hasn't escaped cuts, added 80 people last year but will likely slow hiring this year to perhaps a dozen.

Barclays was the beneficiary of Lehman's collapse, absorbing its book and cherry-picking talent, including Lehman Global Commodities Head Satu Parikh. The unit is run by Global Co-Heads **Joe Gold** and **Roger Jones** and overseen by **Benoit de Vitry**, who also supervises emerging markets rates and quantitative analytics.

Deutschebank, whose commodity unit is run by **David Silbert**, remains in an expansion and expects to gain ground on its rivals.

Touradji, BlueGold, Galena, Clive Boosting Commodity Funds

Hedge funds raising capital or starting new funds include Touradji, BlueGold, Trafigura's Galena and Clive Capital. Hedge funds that started commodity units last year include **Harbert**, with **Hal Lehr**, a Soros and Caxton alumnus leading the effort, and **Millennium**, whose energy team is led by **Kevin McNamara**, lured away from Goldman. **Energy Capital Partners**, a private equity fund run by Goldman alumnus **Doug Kimmelman**, is raising its second fund, about twice the size of its \$2.25-billion first fund, to invest in companies and assets in renewable, power plant and transmission, midstream gas sectors. **Graham Capital** also added commodities trading last year.

Another sign of the shifts underway is the purchase of trading units by companies engaged in production rather than their acquisition by financial services companies.

Lehman Commodities **Chairman Chuck Watson**, whose **Eagle Energy Partners** had been acquired by Lehman in 2007, went back to his group when **Electricite de France** acquired Eagle out of bankruptcy. EDF also bought half of Constellation Energy's nuclear power plant fleet.

Investors Tiptoeing Back to Changed Commodity Trading Landscape

Looking ahead, a Barclays survey of institutional investors suggests their rush to the exits that pressured prices downwards may be temporary. The study said about 75% of the institutional investors in the sample plan will put more than 5% of assets into commodities in the next three years, albeit with more sophisticated strategies than before, when directional bets were

common as commodity returns beat the S&P500 five years running. Redemption selling by institutional investors has peaked, according to a Morgan Stanley report.

Energy, followed by agriculture and industrial metals, were the commodities of choice among respondents in the Barclays survey. More than 80% said oil would average \$75 a barrel in the next five years. Early market indications in 2009 already show increased activity by non-commercial investors.

That bullish view drew support from the steeply rising shape of the oil futures forward curve as the New Year turned, which suggests Nymex oil futures will rise 30 percent by December. Similar curves show optimistic views on copper, corn and gold.

They're Gone – and They're Not Coming Back

Fundamental factors supporting the bullish view include a view that the trillions of dollars governments around the world are throwing at banks, car companies, consumers and homeowners will begin reviving demand and the economy in the second half. The bulls also eye the usual culprits: Opec production cuts, turmoil in the Mideast and Russian interruptions of natural gas to Europe. And of course, Lehman, Bear and the other casualties are gone and they aren't coming back – helpful to the banks still trading, if not to prices per se.

The bear case, of course, lies in the prospect of a prolonged global economic catastrophe. Metals companies – Alcoa, Rio Tinto and UC Rusal -- are

shutting mines, slicing capital spending and laying off by the tens of thousands. Home foreclosures in the U.S. are set to rise further, cutting into the consumer demand that supports prices of everything from oil and copper to corn, wheat and soy.

One successful commodities trader at a well-known multi-billion dollar hedge fund holds that commodities will be “bumping along the bottom for most of the year,” requiring “a lot of fast tap dancing” to stay up with or ahead of the markets. For the medium term, commodities trading profits may come from related equities, debt, private equity and distressed assets investing, the trader said.

That will be bolstered as some of the banks inheriting commodity assets in the restructuring of Wall Street may put them up for sale rather than deal with regulatory and operational issues. And steep debt loads among power plant owners and oil and gas exploration companies are forcing other asset and debt sales.

In some ways, the economic storm has changed the shape of trading – perhaps for a long time. Continuing credit tightness and tougher risk limits are likely to crimp trading, particularly in illiquid over-the-counter markets such as coal, freight, gas and power and basis trading in general. And the dizzying declines of the past six months are likely to reduce appetite for what has always been a volatile asset class among many still nursing wounds.

Memories of the Great Commodity Crash of 2008 won't fade quickly.

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