

## Who Did Well When Oil Tanked?

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Navigating the financial markets is all about predicting the future. Yet very few of the brightest minds in finance foresaw the precipitous crash in oil prices that began late last year. Not even Carl Icahn, one of the most respected fund managers in history.

He entered the fourth quarter of 2014 riding big bets on energy companies such as Transocean, an offshore drilling contractor, and Chesapeake Energy and Talisman, both oil and natural gas producers. When the price of crude tumbled, Icahn Enterprises lost \$478 million in the final quarter of the year, resulting in an annual loss of \$221 million, according to Forbes. This was the first down year for Carl Icahn since the financial crisis. But there were winners. Brown graduate Zach Schreiber's PointState Capital made \$1 billion from betting against oil, and managed to return 27% after fees in 2014, a year in which the average hedge fund returned 2%.

For decades, the supply and demand infrastructure of the world oil markets was almost entirely dictated by the international oil cartel OPEC. On November 27, 2014, OPEC announced it would not institute a supply cut, turning a steady decline in oil prices into a rout. At the same time, American producers were flooding the world oil market, too. It was expected that OPEC would cut supply to arrest the slide, as had always been the case in the organization's history. The decision not to had a devastating impact on American energy producers, who are burdened with high amounts of debt, and decreasing demand for their services.

According to Reuters, there were \$72 billion in leveraged loans outstanding in the U.S. for energy companies at the end of October.

Speculators are drawn to the oil market because oil prices are very volatile: relatively small shifts in supply and demand have dramatic effects on price. Zach Schreiber's bet against oil was motivated by his belief that oil producers in the central U.S. region would keep building supplies, thus leading to a collapse in price, Bloomberg reports. Stanley Druckenmiller's former star trader made a bet just as profitable as his mentor's British pound trade.

But now many investors see oil as an opportunity. Cornell graduate Seth Klarman '79 is the CEO of The Baupost Group and provided the lead gift for the construction of Klarman Hall, a new humanities building attached to Goldwin Smith Hall. His Boston-based series of investment partnerships (he prefers not to use the term hedge fund) are known for investing only when they find a bargain. According to Bloomberg, cash accounted for 40% of Baupost's portfolio at the end of 2013. In 2014, Klarman found bargains, and they were in the energy industry. In his annual letter to investors, Klarman wrote, "Baupost wasted no time in redirecting additional investment team members into the energy area to sift through the carnage." According to Bloomberg, Klarman invested further into companies including Cheniere Energy Inc. and Antero Resources Corp.

Private equity firms, or firms which purchase companies in leveraged buyouts, struggled in the immediate aftermath of oil's collapse. When oil was expensive, private equity firms wanted to benefit from the American shale boom, and according to Joel Moser of Aquamarine Investment Partners, a firm that has invested in the sector for decades, "[All] sorts of folks who would never have dreamed of oil and gas piled in, often loading companies with debt." According to The Economist, Carlyle Group's earnings were negatively impacted by its stake in SandRidge Energy, "a debt-laden oil-and-gas exploration company, which lost 58% of its value over the quarter and has just announced that it is mothballing most of its drilling rigs."

Investment bankers who earned enormous fees from helping companies raise debt are now earning fees helping firms restructure their debt. In an interview on Bloomberg Television, Blackstone Group's restructuring head Tim Coleman said,

“We’re probably looking at 80 names that are, in some form or another, struggling. We have a lot of new assignments, both on the debtor side and on the creditor side.”

In addition, private equity firms see opportunities to use their own money in the energy sector. Blackstone’s CEO and founder Stephen Schwarzman said in December that the collapse in energy would be a “wonderful, wonderful opportunity for us.” In fact, Blackstone is raising its first energy-focused credit fund, hoping to capitalize on some opportunities that arose from the steep drop in asset prices. Blackstone plans that the fund will grow to between \$2.5 and \$3 billion. The fund hopes to invest in liquid distressed securities across the energy sector.

The art of investing is finding value that other investors cannot see. By launching credit funds and private equity funds, firms like Blackstone seem to signal that they have an insight about the recovery of the energy sector that others do not understand. However, oil continues to be under pressure because of continued supply and a strong dollar; oil is priced in dollars, so when the dollar rises, oil becomes more expensive for non-dollar buyers. If the dollar continues to appreciate, the oil trade will become even trickier.

Mark Vaselkiv, who manages T. Rowe Price’s nearly \$10 billion high yield fund, believes that “we are probably only in the second inning of this correction. We don’t see prices getting back to where they were a year ago.” Mr. Vaselkiv believes the progression of the boom in the American oil industry followed Warren Buffett’s idea of “innovators, imitators, and incompetents” sequence. With money flowing into the sector once again, it will be interesting to see who the real innovators are.