



**Rockwood Energy Search LLC**

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## Hiring Strategies for Trading Organizations

With the credit meltdown slowly dissipating, a few organizations are beginning to think of growth.

Some will grow steadily and profitably, others will struggle and others will fail. Already we've seen some rather smooth startups and some near failures. What's bothersome is that some of the firms appear to be making the same mistakes as those in the past.

Our search firm has been through a number of startup cycles since 1986.

The growth of energy derivatives shops in the mid to late 80's, e.g., Bankers Trust, Enron

The growth of natural gas trading floors in the late 80's, e.g. Natural Gas Clearinghouse/Dynegy

The startup of power trading in the early 90's

The surge in new hedge funds occurring in the early 2000's.

### The Critical Flaw

What many forgot in the past was that Trading is not generally a pure profit center, it is a function that supports a corporate strategy. For all but the hedge fund or commodity trading advisor, trading is not the main business.

How will Trading fit within the business, and what function will it perform? What will be the risks associated with this trading function? Will it reduce the firm's overall risk or increase it?

If there's no strategy, there's not much way to design and implement an effective trading organization.

Even where it seems to be pure trading--in the world of commodity trading advisors or hedge funds, the lack of an overarching market view or trading strategy is equally fatal.

So, I would maintain that a strategy comes first, even an oversimplified one. Then you can design a trading group that will generate maximum profits *for that strategy and that risk level*. Then and only then can one hire the kind of staff that will be the most effective and the least stressful for senior management.

### More Choices Now

As the array of on-exchange/off-exchange energy products have grown and the emergence of RTO's become realized, there are more choices of how to create a trading group. What products should I trade? What region? What risk profile should I have? How much physical trading is necessary?

And there are different types of risks now—credit is an even bigger issue than in the past, but also there more execution risks with complex products and more market risk given more volatile energy prices.

But there's always a place to start—what is your present business and how can trading help you? From that simple starting point, one can evolve a view of the benefits and costs of trading.

### **Contrasts in Trading Organization Profiles in Financial Services**

*Customer-Oriented Market Making:* The most common example of this are the commercial banks that have been in energy lending or energy finance and have not gone into physical trading.. The ones that come to mind are Calyon the French bank and BNP Banque Paribas(before the Fortis acquisition).

These firms are using trading to extend and capitalize on their credit facilities that they provide to energy firms.

They make markets in fairly liquid instruments that their clients need, e.g., natural gas derivatives, crude and products derivatives.

In these types of trading shops, the traders are expected to make relatively narrow markets in various products, work closely with the marketers to price deals quickly and manage the risks in their portfolio of deals. They are not expected to take great risks nor do significant proprietary trading.

Most trading organizations will take a view of the market and put on proprietary bets, but for the market making firms, proprietary trading is a small proportion of the activities.

The traders in this type of organization are paid well, but not paid generally as a percentage of their book or profits. They are---and should be--- encouraged to do many deals at a decent margin, facilitate the trading of the firm's customers and be able to structure deals creatively.

Contrast this to a pure hedge fund trading firm or commodity trading advisor.

*Pure Speculative Trading:* Individuals in this type of firm don't deal with customers, or in some cases have no clients, only counterparties that they trade with and whose credit they will accept.

The traders in this environment are paid on an incentive basis, and don't have to worry about relations with clients. They don't have to structure deals, provide prices to marketers, or be worried about providing liquidity to anyone. They are paid to trade and maximize profits. If they make money at the expense of another market participant, that's the rough-and-tumble nature of the business.

### **The Difference in Trader Personalities and Organizational Implications**

One can envision the difference in the staff between these polar opposites.

The market-making trader is more cautious, more risk-averse and more marketing-oriented

The Spec trader is aggressive, willing to make significant bets if the market is going his/her way.

Neither should be foolish and both should know how to manage risks carefully.

Where many firms have gone wrong is that they have not specified where they are on the spectrum between market making and proprietary trading. Then they have hired traders of various risk profiles and expected them to behave “appropriately.”

What’s appropriate to a proprietary trader and what’s appropriate to a market-maker are quite different.

So, we’ve ended up with prop traders in energy trading firms with no ability to manage prop traders, and market making traders in prop trading jobs—where they don’t know how to take the big bet when it’s time.

### **It Starts With Trading Management**

The key individual in the trading organization equation is the person responsible for all trading activities. If this person is accustomed to running a market-making shop, he/she can run another such shop.

A proprietary trading manager is likewise able to run a proprietary group.

Some can do either, but that’s not so common.

*Choosing this person and his/her attributes and leanings is key.* It sets the tone for the group, plus the skill sets are different. In addition, this person is going to hire the traders and manage them, so any biases of the manager will be seen in the resulting hires.

### **Other Types of Trading To Be Found in Energy Firms**

Among the various types of organizations are:

*Asset Optimization Trading*---Typically found in an electric utility, this occurs as trading carefully manages a portfolio of fuel purchases and power offtakes (or contracts) destined to insure that the generation assets yield the greatest return. This type of trading buys additional fuel or power for the spikes in power needs, or buys additional power to be used instead of running an inefficient plant.

Such an approach can actually lower total risks for the company while generating greater return. Traders in this type of an organization tend to be more analytical and steeped in generation economics than the average market-focused financial trader.

*System Supply*---a group that buys crude oil for a refinery in much the same way a asset optimization group buys fuel for power generation. This type of trading also might buy refined products for re-sale when the refinery goes down for periodic maintenance. Has much in common with asset optimization style trading.

*Pure Portfolio Management*—frequently found in retail energy firms with no captive generation, this generally means that traders are buying power or gas for future delivery to a set of commercial or industrial clients. The main goal is to balance the requirement for varying volumes of power or gas in the future versus minimizing the cost of supply. Since many agreements in this business provide fixed prices at variable volumes, there’s a large volumetric risk. Traders work closely with forecasters to estimate needs, and do what they can to hedge against sharp swings in volume.

### **Determining Where One Should Be On The Spectrum**

Rockwood has worked with all types of trading organizations and can assist with examples of types of trading organizations that might be appropriate.

In addition, we know enough management people in the trading business to be able to talk about the trading management personality and how best to hire the right person.

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