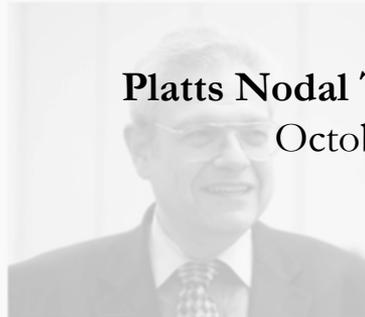




# Risk Hedging vs. Manipulation



**Kevin J. Gates**  
VP of Managing Member  
Powhatan Energy Fund LLC



**Platts Nodal Trader Conference**  
October 9, 2014



## Here's my background.

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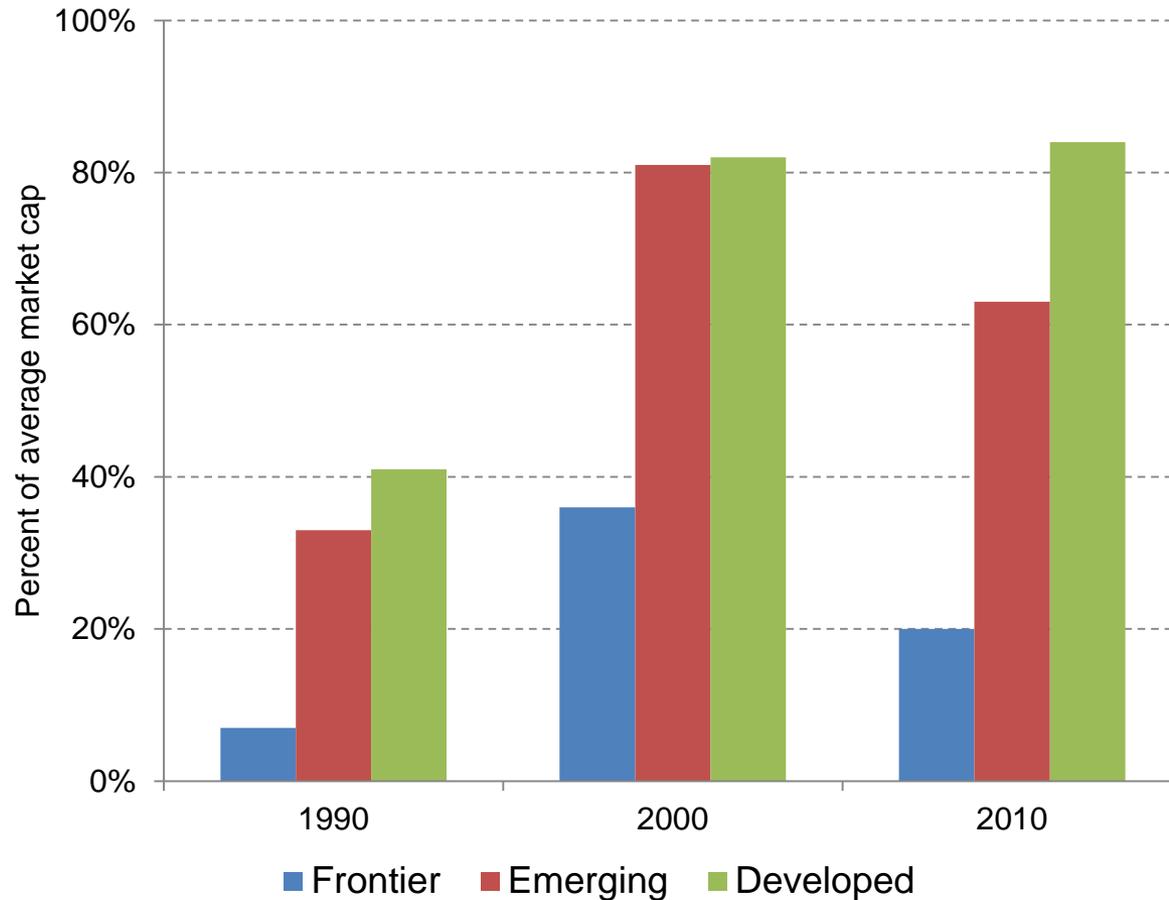
- My brother and I started TFS Capital\* 17 years ago using money borrowed from credit cards.
- TFS Capital is now an asset manager with over \$1 billion under management, including 3 SEC-registered mutual funds.
- TFS Capital is an SEC-registered investment advisor and a commodity pool operator registered with the CFTC.

\* TFS Capital is unaffiliated with and unrelated to Powhatan Energy Fund LLC.



# Open markets beget liquidity in equities.

Turnover ratio for equities as a percentage of average market cap



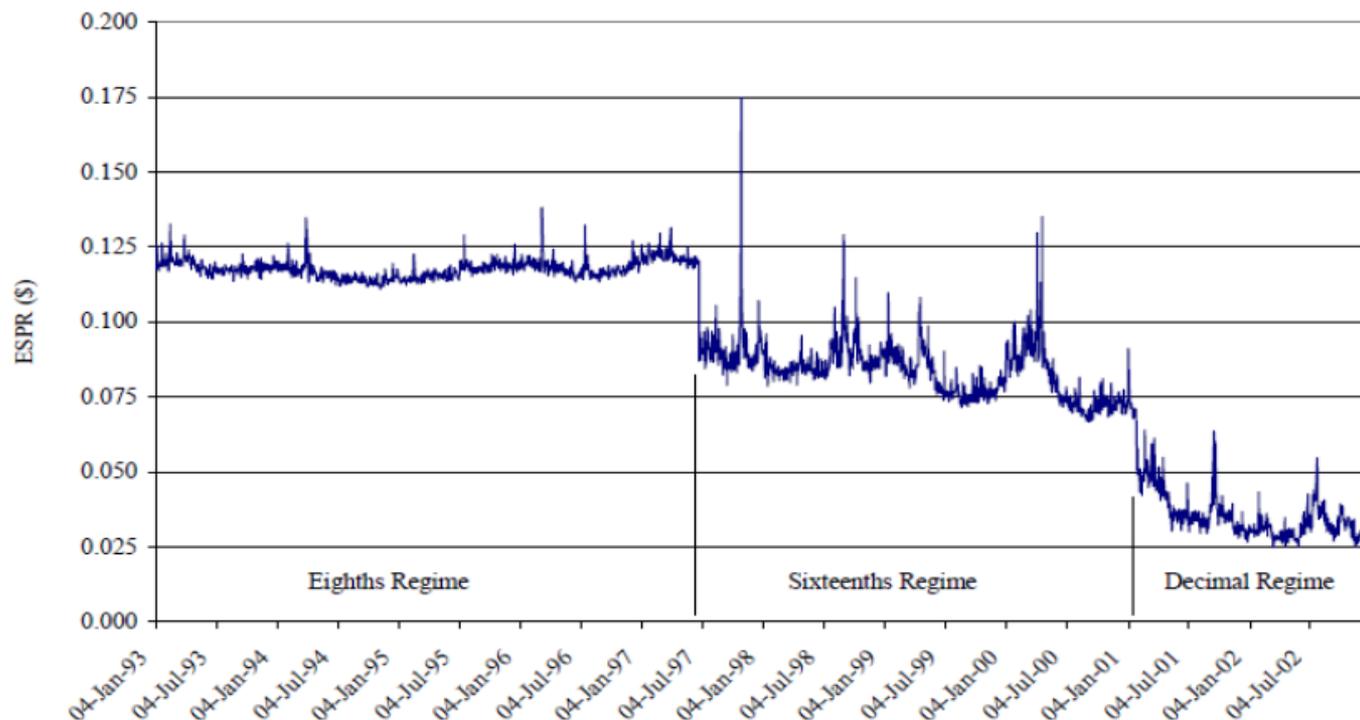
“[F]rontier... markets are less developed and are generally riskier in terms of liquidity, market structure, and political climates... relative to developed markets (and also, one could argue, to emerging markets).”

Source: Vanguard, *Exploring the next frontier: A review of frontier equity markets, January 2013*



# US equity markets are good, and getting better.

## Value Weighted Daily Average Effective Spread, NYSE, 1993-2002



*“... the good part of high-frequency trading is that the intense competition between high-frequency traders had driven the costs of trading very close to zero. They’ve never been cheaper, so maybe sometime I’m going to have to rethink the idea that trading costs reduce the returns of investors.”*

- Jack Bogle, July 2014

Source: Equity Trading in the 21<sup>st</sup> Century - Angel, Harris and Spatt (2010)



## I know about the equity markets.

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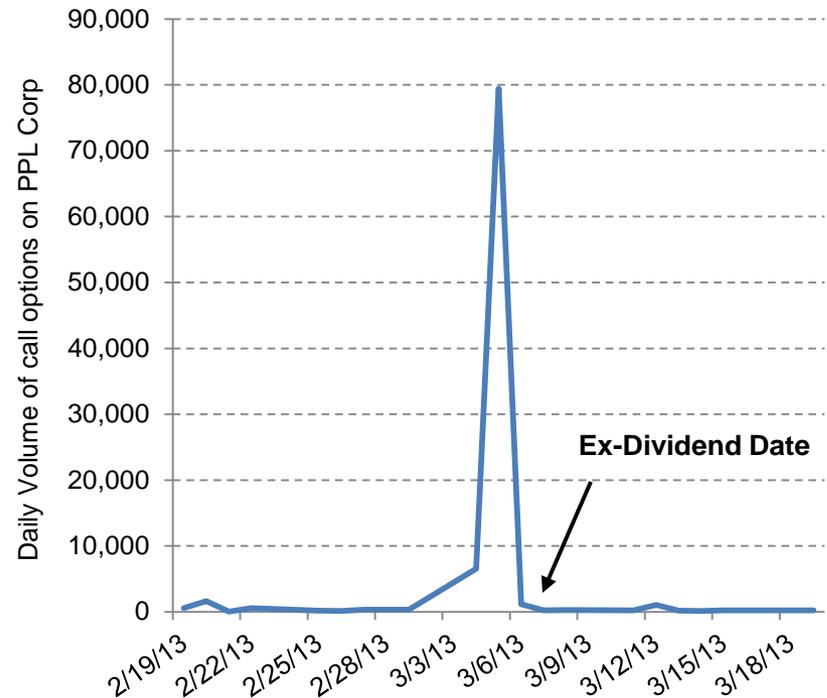
- Trades that are “uneconomic” but for rebates are economic because of those rebates.
- Spread trades are where a trader takes offsetting positions in two closely related contracts, attempting to obtain a benefit while taking on limited market risk. They are ubiquitous.  
*e.g* Long BRK.A, short BRK.B.
- Covered call strategies are common.  
*e.g* Long SPY, short call options on SPY.
- Arbitrage across markets creates equilibrium and stability.  
*e.g* Long SPY, short S&P 500 futures.

It's OK to expect to lose money on your hedge. They are insurance policies. You should expect to lose money on insurance – that's why Warren Buffett owns Geico.



## I know about wash trading in the equity market.

- Wash trades aren't *per se* manipulation – only if done with the objective of introducing false information into the markets. Peter Kellogg could have had ulterior motives for his wash trades – didn't matter.
- Wash trading can help expose structural inefficiencies in the markets and get you in line for a Dodd-Frank whistleblower with the SEC.
- Ex-dividend arbitrage makes graphs like this by executing large, simultaneous offsetting purchases and sales in the same options series.



Source: Bloomberg Professional

# Wash trades are problematic when their sole purpose is to deceive

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Nasdaq

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