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BURKE
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Energy Stocks – Stocks with No Energy

Many of you have recently asked us about energy stocks. Our experience is such that if a few clients go so far as to ask us a particular question, many more have the same question. On that note, here are our thoughts on the energy market as a whole, and on certain sectors within the energy market.

The obvious issue is that energy stocks have trended down for quite some time now. The underperformance started on June 23, 2014. On that day, Israeli jets attacked nine targets inside Syria, sparking concern about a widening conflict in the Middle East. Energy stocks rose sharply that day. Since then, however, the S&P 500 has returned just over 6% as a whole, while energy stocks have lost 32%[1].

Energy stocks, as we define them, are companies that either capture an energy resource, or are involved in its storage and/or transportation to market. These include drillers, equipment makers, coal miners, pipeline companies and vertically integrated companies. The integrated companies are involved in all aspects of oil and gas production, and delivery, and include the best known companies like Exxon and Chevron.

Roughly 8% of the S&P 500 index is made up of energy stocks (by market cap).

Growth investors long ago sold energy stocks because earnings are shrinking (not growing). Generally, value investors are the only buyers. Value investors like to buy stocks when they are undervalued, hoping for a rebound in earnings.

Stock market investors, however, can't help but notice how much the stocks have gone down.

Often, I hear clients ask "but why is (fill in the blank) down more than the other energy stocks?" That answer generally has to do with timing. The worst time to buy energy stocks was in mid to late 2014. Those purchases would likely show the largest loss. Purchases made before December of 2010 generally show a gain.

Relatively conservative energy stocks, like Exxon, show the smallest loss when compared with other companies over the same period. In down times, these vertically integrated stocks have historically lost less money.

We believe that diversified investors should have an allocation to energy in their portfolio. Energy stocks can be considered hedge stocks. If war breaks out in the Middle East, these stocks could go up like they did on June 23, 2014. In that example, violence did not lead to an interruption of energy supplies. If they did, however, economic activity would have suffered and those energy stocks could have been in the minority of investments that performed well.

Energy stocks are generally down for the same reason. The prices of oil and gas are down. If those prices go back up, these stocks will generally go up. Investors with long time horizons might be wise to buy energy stocks now, after all, it is wise to buy low. Aggressive investors might even consider buying the less stable energy stock.

It is the less stable names that have gone down the most. If oil goes up, these stocks could actually go up the most. But only very risk averse clients should consider such an investment.

We generally like the higher dividend names. If you own stocks with us, you likely own some high dividend energy stocks.

Raymond James has a well-respected energy research department. They have pointed out that demand for energy, especially oil, has increased as the price has gone down. This makes sense. In fact, it is often said that the cure for low oil prices is low oil prices. That is, low oil prices spurs demand. Demand has increased worldwide.

Oil prices can also cause supply to change. Low prices can cause heavily indebted operators to go out of business. High oil prices encourage new drilling.

Less predictable are events that might cause a large change in supply. Many commentators are wondering if Russia has gotten involved in Syria for reasons that are self serving. For example, might Russia be putting themselves in a position to broker a deal between Saudi Arabia, the world's largest exporter of oil, and Iran? The two countries have been notoriously hostile to each other. Iran is said to be sponsoring the revolution in Yemen which borders Saudi Arabia.

We think it is possible that Russia might look to persuade Iran to withdraw from Yemen in return for a Saudi agreement to cut oil exports. It was the Saudis who started the freefall in oil prices last year by increasing production.

Russia, Saudi Arabia and Iran are all major exporters of oil. All would benefit from higher prices. Therefore, it would make sense for such a deal. Further, the Saudis were not happy that many OPEC (the oil cartel) members were ignoring the limits on oil production that existed before 2014. Since all have suffered, there may be a willingness within OPEC to have more discipline with oil production going forward.

We do not have any nonpublic information about any of this and yes, perhaps we are speculating as to what might happen. But oil tends to be an unpredictable commodity. Further, energy is the one commodity that can neither be reproduced (like food commodities) or recycled (like metals). Once used, it is gone.

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The production of oil has been in “over supply” by only about 2 to 3%. But it has been in over supply for some time, leading to a market glut. Terminals in Cushing, Oklahoma are full. Tankers are floating at sea looking for a place to sell their oil. This is what you see when oil falls from over $100 a barrel to less than $40 a barrel.

Last week, a Russian fighter jet was shot down over Turkey. Oil prices went up ($42.70 a barrel as I write) and energy stocks led the market up. What happens next is highly unpredictable.

In the spring, we had recommended that investors lighten up on energy holdings. We are now generally recommending clients hold their energy stocks, though your specific situation may warrant a different strategy.

As is always the case, please call us with any questions or concerns.

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[1]S&P 500 Energy Index