



Black Gold, Texas Tea

By Robert Huebscher

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The flow of money into gold-related funds is, at least in part, driven by good intentions – hedging against dollar debasement, inflation, and systemic risk. As investors drive the price of gold to record levels, though, they are overlooking an equally compelling commodity hedge, one that the *Beverly Hillbillies* once dubbed “black gold, Texas tea” – oil, that is.

The case for oil is rooted in its scarcity, which, unlike gold’s, is accelerating because of its commercial use. Peak oil is the working hypothesis, and it states that the rate of oil extraction eventually reaches a maximum level, after which it recedes into terminal decline as dwindling reserves become increasingly difficult to tap.

Peak oil has been repeatedly observed at the level of individual oil wells and, as logic then dictates, at the country level, where, for example, US production peaked in 1970.

Nonetheless, peak oil has its disbelievers and detractors; if you are one of them, you are unlikely to agree with what you will read below. You might, however, find comforting voices in the mainstream media. In a November 16 *New York Times* [section](#) devoted to energy issues, for example, Clifford Krauss wrote, “Energy experts now predict decades of residential and commercial power at reasonable prices. Simply put, the world of energy has once again been turned upside down.”

Such claims are “unforgivable,” according to Dick Vodra. Vodra, who is President of Worldview Two Planning in McLean, VA, is perhaps the leading authority on energy issues in the advisory community. I spoke with him last week.

With Vodra’s help, I will review the arguments pointing to an inevitable decline in oil supply and the corresponding rise in oil prices, and I will then turn to the role of oil-related investments in one’s asset allocation.

Peak supply but not peak prices

The most recent data, Vodra said, say that global oil production has been on a plateau since 2005. Price increases and demand growth over that time frame have failed to increase production.

Vodra noted that the UK Industry Task Force on Peak Oil and Energy Security recently reported that 29% of new production of oil will come from deepwater oil, even though that source now represents less than 5% of global production. The recent British Petroleum disaster makes that prediction suspect, he said, but even if it were accurate, it implies an



incredible decline in the rate of production from land oil and a dramatically increased reliance on more expensive deep-water drilling.

Most observers in the peak oil camp predict global production will begin to decline in this decade. One such authority is Nathan Lewis, a professor at the California Institute of Technology. Lewis has stated that energy is the “single most important challenge facing humanity in the 21st century.” Based on projected rates of consumption and population growth, Lewis believes there are between 50 and 100 years’ worth of oil remaining on the planet.

Skeptics can counter that oil companies have 40 years of proven oil reserves and that this figure has been constant for the last century. Lewis, however, says such numbers merely reflect the economics of the oil industry. Oil companies have little incentive to explore and develop new reserves beyond a certain point.

More broadly, Vodra fears the “drill, baby, drill” mindset is winning out over initiatives like cap-and-trade, which would have imposed economic penalties on carbon production and, he believes, would have stimulated the research into alternative energy sources that could relieve the world’s reliance on oil. Last year’s Copenhagen conference failed to produce any meaningful answers. Now, Vodra fears “nobody in authority is interested in developing an economy that doesn’t use fossil fuels.”

A lack of leadership, particularly with respect to energy conservation, is making Vodra increasingly pessimistic. He faulted the President Obama for failing to use the BP oil spill as an opportunity to spark conservation efforts. That crisis is largely forgotten, he said, and Americans are back to buying SUVs in record numbers.

Political gridlock is a main factor hampering the development of alternative energy sources and continuing our dependence on oil. Ramping up an effort on the scale needed to tackle the problem head-on, Vodra noted, will likely take years and significant up-front expense, exacerbating the inertia. The large capital outlays necessary to implement programs like building new coal plants, windmill farms, or funding research and development on photovoltaic technology, Vodra said, requires “up-front capital we don’t have.”

The only good news on the energy front that Vodra cited was that the Republicans in the House appear to be taking on the ethanol subsidy, which Vodra called “pointless” and “a waste of money.” “It’s a farming program and not an energy program,” Vodra said.

Mostly, though, Vodra worries that there is simply no more easy oil to get. “When oil breaks triple digits,” he said, “it becomes unaffordable, and we go into another recession.”



The energy-efficient portfolio

Oil prices could break triple-digits once the economic recovery accelerates. Or it could happen in a modestly-paced recovery in developed economies, since the demographics and energy usage patterns in Asian economies will more than make up for weak demand in the West.

Moreover, major oil supplies are controlled by unstable countries, like Venezuela and Iran, which are unfriendly to the US. Political instability anywhere in the world could trigger a sudden spike in oil prices. For precisely this reason, oil is a valuable hedge against systemic risk – and it can be a better hedge than gold in times of severe crises.

Any broadly diversified portfolio is exposed to oil prices. The question for investors is whether to overweight oil and use it proactively as a hedge against certain risks.

Vodra has been a pioneer in constructing portfolios based on a vision of a world with depleted oil supplies. Several years ago, we [wrote](#) about his “Worldview Two” portfolio, which he created to offer broad exposure to energy production, global currencies and global bonds. It is not specifically designed to exploit the role of oil as a hedge or as a commodity whose price is destined to rise. Rather, it gives investors a way to defend against a scenario that includes broadly rising energy and commodity prices, a weak dollar, and either inflation or deflation.

Another approach to gaining exposure to oil is through individual stocks. Charles Maxwell, the Senior Energy Analyst at Weeden & Co., spoke about this approach at the recent Advisor Money Show in Orlando. Maxwell is squarely in the peak oil camp.

Measuring a company’s proven oil reserves per dollar of its share price is the best guide to selecting securities with the best oil-based value, according to Maxwell. His top recommendation, based on this ratio, is Cenovus, which is listed on the Toronto and New York exchanges and has approximately six billion barrels of reserves in the Athabasca tar sands. He also recommended Suncor, which is also a Canadian company, and Lukoil, a Russian company without any government ownership.

Maxwell called these “long-life reserve” companies, which can increase their production year-after-year and take advantage of rising prices.

Either Vodra’s or Maxwell’s approach, however, exposes investors to numerous risk factors other than the pure price of oil. To hedge with oil, investors need exposure to the pure commodity.

One way to do this is through one of the many oil-based ETFs, such as USO or OIL. The problems with this approach, though, are well known and well documented. For the last two years, the oil futures markets have been in “contango” – prices are increasingly higher



for contracts with delivery dates further into the future. As a result, much of investors' return in futures-based strategies is lost as the current contract is sold and a new one is bought.

Investors can sidestep the contango problem by using a long-dated futures contract. The December 2019 contract last settled at \$91.71/barrel. As Vodra told me, it is hard to imagine oil not piercing the \$92 price level over the next nine years.

The options market offer yet another way to hedge directly using the price of oil. Options on oil futures trade on the CME exchange. One can purchase options with exercise dates two years or sometimes more into the future. An out-of-the-money call option (with a strike price far above the spot price) can serve as inexpensive insurance against extreme events.

Oil trades at roughly \$84/barrel in the spot market. Unlike gold, no one fears it is in a bubble. Oil prices are certain to be volatile, as supply and demand are likely to be in a tight equilibrium for the foreseeable future. If an investor can tolerate this volatility and take a long-term view, based on a belief in peak oil, then increasing his or her exposure to oil is a prudent – and potentially profitable – step to take.

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