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Oil and Gold

Source : acheteror.org

Source : Radio-Canada

People often ask me if they should invest in natural resources such as gold or oil, and why I don't recommend stocks in those sectors. I very well understand the reasons that would make you want to buy them and to believe that they are good investments. After all, we are proud to live in a country that is rich of natural resources. Also, there are many companies from these sectors that are in the Canadian market, which means that we regularly hear about them and that they are often recommended by portfolio managers and analysts.

Worst of all, the performance of the Canadian market, the S&P/TSX, is directly related to the performance of these natural resources that, despite the recent low, still represent about 35% of the index compared to 25% in the previous years. This means that if the stocks for oil and gold rise quickly, it would be difficult for Canadian portfolio managers to match the return of the benchmark if their portfolio under-uses natural resources. Useless to say that almost all of them use some. So why not you?

Before answering this, let's try to understand this sector a little more.

Essential Natural Resource

Oil and gold are natural resources used as raw materials for many goods. Gold is primarily used for the making of jewelry and decorative objects. We may also find some in technological and high tech components because it is unalterable, malleable as well as a good conductor of electricity and heat. Gold, the symbol of power, is used as refuge in the uncertainty and protection against devaluation of money. Oil, once transformed, is used as an energy source for cars in the form of gas, for the airplanes in the form of kerosene, a heating source for our homes in the form of oil fuel or natural gas. We also find oil in the fabrication of plastics, lubes, asphalts, etc.

The worldwide price for oil (Brent) and gold is fixed in London in American dollars and it's affected by law of supply and demand. The fluctuations in price of these commodities directly affect the value of their underlying companies in the stock market. For example, if you own a mining company and it costs you $1 300 US to extract an ounce of gold once all of your other expenses are taken care of, you will make a good profit if you can sell it at $1,500 US each ounce. If on the other hand the price of an ounce of gold is only $1 200 US, you will lose money each time you take an ounce of this rare metal out of the ground. It's exactly what is happening nowadays. At a price of about $1,170 US for each ounce of gold, most mining companies are incurring losses! Just as the price of a stock in the market ends up following the progress of a company, it is difficult to get rich while holding a company that regularly loses money!

The same goes with oil. The problem, is that these companies have no control over the selling price of their raw material. The companies in these sectors are very cyclical, in the sense that most of them can make a lot of money on some years and lose a lot of it a few years later. Even if they are well managed, they will always have a cyclical behaviour.

We won't miss oil!

Here's an interesting debate. Environmentalists believe that this is a limited resource and they wish to see a rise in its price in order to reduce the consumption of this commodity, while other experts are saying that our reserves are enough for many decades to come.

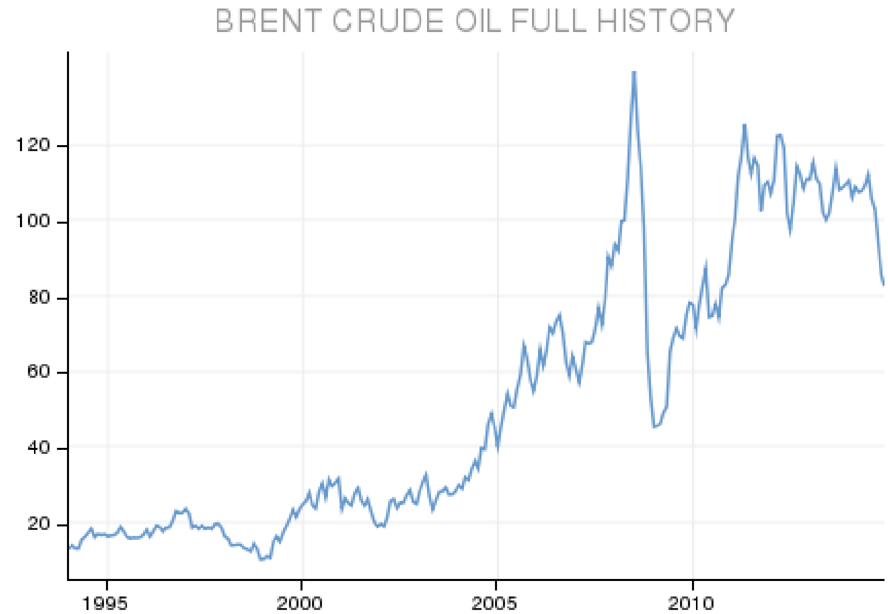
Source : agricorner.com

The price of a barrel of oil has fluctuated a lot throughout the last few years. Contrary to many opinions, nothing guarantees that its price will go back up to its price of 2008, being $147 US per barrel. In fact, while the worldwide demand for oil remains fairly stable or in slow growth, there is a strong growth in supply. Supply increases due to the discovery of new oilfields, the exploitations of shale gases and oils, new drilling, new processes, etc. Even the United States expect to be energy self-sufficient by 2030[i].

People often forget that the barrel of oil used to sell for less than $20 about 16 years ago and has even reached a low of $9.82 the barrel in December 1998. Useless to say that very few companies were profitable at this level, and many oilers had to shut down! Such a low price encourages overconsumption, as well as the waste of this resource. Between these two extreme situations, there is most likely an acceptable price. At 80$ a barrel, we're getting close to a reasonable price. But at this price, there will be companies that won't be able to cover their expenses. In other words, if the price of the barrel doesn't go up soon, many companies will show great losses in the coming quarters!

A large part of Canadian oil comes from Alberta's oil sands. This causes a problem because, contrarily to conventional oil exploitation, oil sand transformation is a complicated, costly and very pollutant process. In fact, producing a barrel of oil from oil sands requires 2 to 4 barrels of water in which must be disposed of later on. These used waters will quickly become a serious environmental problem. Secondly, this creates a lot of greenhouse gases and about 20 to 25% more than conventional oils[ii].

With a highly pollutant energy source that is more and more expensive to extract and transform, we ask ourselves if the tendency of this commodity will ever cease to increase. The more expensive a product is, the less demand there will be for that product. It's common sense. Other less pollutant sources of energy will come into play. The Stone Age is over, and not because we have no more stones left! Among the other interesting alternatives sources of energy, there is nuclear energy, electric, wind and solar. The baby-boomers who will retire will most likely not need two cars per couple.



Source : Quandl

On the big graph above, we can see the strong speculative rise that has abruptly ended in July 2008, before starting to go back up. Too fast of a rise is unsustainable because it frustrates the consumer who has no choice but to change his transportation habits. This could in fact reduce demand, which inevitably reduces the price of oil.

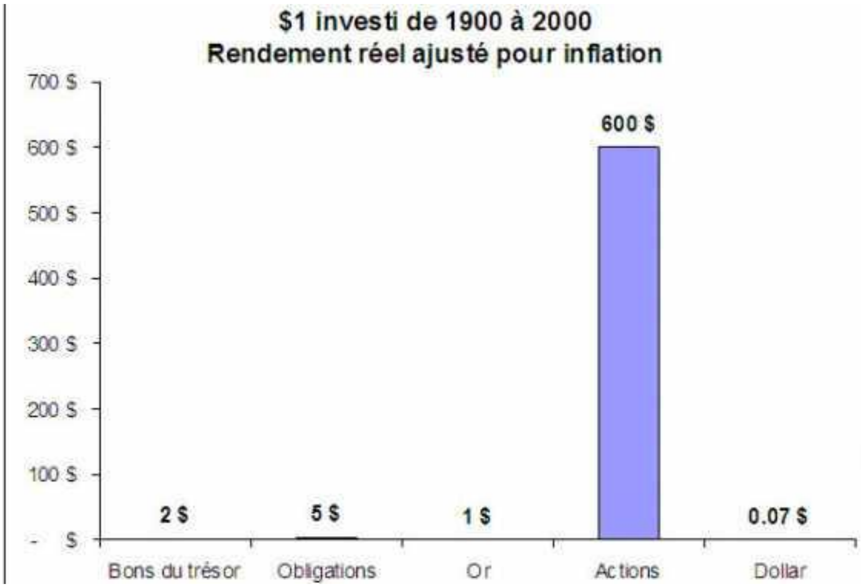
"The Stone Age didn't end for lack of stone, and the oil age will end long before the world runs out of oil."
Sheikh Yamani – Ancient Saudi minister of petroleum, October 2005

A protection against inflation

Gold has a reputation of being useful to protect yourself against inflation. While the dollar has lost 93% of its value during the last century, gold has maintained its purchasing power. This very coveted raw material is however not the only asset used to prevent inflation's undesirable effects. Real estate (your house) does this job quite well. Even stocks can take advantage of this (while inflation is under control) because companies try to protect their profit margins by passing on price increases to consumers.

Source : Lyon Capitale

Despite the massive indebtedness from governments on a worldwide scale, nothing guarantees that we will have to face a strong inflation in the next few years. Governments will do everything in their power to keep control over the situation. Ageing baby-boomers and globalization of the markets are long term phenomenons that have a steamroller effect on inflation. As investors, we must always be suspicious of what is too fashionable! Saying that the price of gold will be over $2,000 per ounce is pure speculation. It may also go down to $500 per ounce with a strengthening American economy. Also, global economy will one day get out of its slump, which should reduce anxiety levels. Simply, no one can predict with full certainty what will happen to the price of gold.



Source: Giverny Capital

As you can see in the above chart, gold can be a good way to protect yourself against inflation, but we certainly cannot call it an investment. We invest to become richer, not to maintain our purchasing power! **Simply put, if your rate of return is the same as the inflation rate, you won't create any real wealth. In order to become rich, you must get a rate of return that is higher than the inflation rate once you have deducted taxes and fees.** Stocks have been by far the best place to invest for the long term.

Gold is not a real investment. It doesn't provide any revenue, and generates no interest nor dividend. All you can hope for is to sell it to someone else at a higher price. As Warren Buffett said in 2010[iii], "You could take all the gold that's ever been mined, and it would fill a cube 67 feet in each direction. For what that's worth at current gold prices, you could buy all -- not some -- all of the farmland in the United States. Plus, you could buy 10 ExxonMobils, plus have 1 trillion dollars of walking-around money. Or you could have a big cube of metal. Which would you take? Which is going to produce more value?"

Beware of fashions!

Currently, the price of an ounce of gold is decreasing compared to its recent peak of $1,921 US. The recent increase in the price of gold is due to the worrying problems we have known such as the biggest financial crisis since the 30's, massive indebtedness of consumers and governments, and the downfall of the American currency compared to other currencies. Everything was exacerbated by a speculative push. People seem to forget that an ounce of gold was worth merely $256 US in May 2001. The reason prices went that low was because international governments preferred to offload a part of their reserve of gold and replace it with a basket of strong currencies. That way it's less cumbersome and more effective to protect against a devaluation of their own currency.

When the price of gold keeps increasing like it did this past decade, some investors buy gold simply because the price is goes up, without asking themselves why they even bought this product or company, and what risk is involved. Does the manager of the company work for himself or for the shareholders? Is the company well managed and profitable? Blindly buying with the hope of making profit is called «speculating». And in this game, the losers far outweigh the winners!

If you are so interested in buying gold, why not buy your spouse some jewelry? You will certainly lose a lot less money than you would if you speculated in gold, and you will get extra benefits!

Should we avoid the natural resources sector?

When a company doesn't have control over the selling price of its product, the long term is non-existent. The company takes advantage of the manna when it passes, and tries to survive by reducing their expenses and their production when the price isn't in their favour. Thanks to derivatives, some producers manage to limit damages. Companies in this sector generally do not have any lasting competitive advantages. They all make the same product.

Moreover, companies in this sector are capital intensive and must continuously inject money to modernize and repair their equipment. The average cost of building a refinery is 6 to 7 Billion dollars and takes about 5 to 6 years. Opening a new mine also costs a fortune. This is why profits are used as a sponge to clean up the mess from the tougher years and to modernize their mines and refineries. What's left for the investor in the long term? Not much. There is no real creation of wealth. Despite the high price of gas these past few years, most companies in this sector are still showing very average to mediocre profitability. These results are even worse among Gold companies. By low profitability I mean a return on equity below 15 % per year.

In the stock market, the companies from this sector follow, in an amplified way, the price of commodities. Just as it's impossible to accurately predict the direction of the price of oil and precious metals, it's hard to know when to enter or exit these sectors. We are instead playing a game of speculation. The stock market is unpredictable! Market timing is a very dangerous guessing game that uselessly increases transactional fees and taxes. While some people were lucky enough to get rich this way, many more others have lost everything. If you want to go «play» in the stock market, you might as well just go to the casino. I strongly recommend to not play with your retirement savings!

In spite of that, it is possible to make money in this sector. Certain companies play their cards well and have passably enriched their shareholders over time, mostly in the energy sector. Here's a basic rule of investing: stay close to your circle of competence. It just so happens that the natural resource sector is not in my circle! Since I don't know any of the managers, it is difficult for me to trust them enough to leave my wealth in their hands. If I don't feel comfortable enough to invest at least 10% of my wealth in a company, would it be worth it? Also, **this sector contradicts my investment philosophy which is to hold uniquely excellent companies that are very profitable, that are growing, have durable competitive advantages and come from non-cyclical sectors** or very little influenced by economic cycles.

In order to succeed in the stock market, we don't have to own companies in every sector of every country. Holding excellent companies from only a few promising and growing sectors is more than enough to obtain a healthy diversification and a satisfying long term result.

How to take advantage of increasing demand in resources?

There is a safer way to take advantage of this cyclical sector. The secret is to buy companies that indirectly gain from the increase in demand of these resources without being affected too much while the worldwide demand decreases and this sector goes through tougher times.

For example, you could buy an engineering firm. When oil companies feel rich and the price of oil is high, they usually want to open new drilling sites, refineries, etc. To do this, they give contracts to engineering firms that are experts in the field. Just as good engineering firms are generally active in many sectors, they are less affected by the decrease in the price of natural resources.

Owning a railroad company is another nice way to benefit from a high demand in resources. Once extracted, these metals and oil must be safely transported. Compared to truck transportation, railroad is the most effective, less pollutant and less costly transportation method for long rides.

In fact, trains consume a lot less energy than trucks, because only one litre of fuel allows it to transport 1 ton of merchandise on a distance of 198 km[iv], all while emitting 6 times less greenhouse gases. As railroad companies transport a diversified range of merchandise, they are less affected by a fall of demand in natural resources like oil or gold. Cereals, fertilizer, chemical products and consumer goods to say the least, take over.

There are excellent companies that are very profitable, well managed, in the engineering and railroad transportation sector. They are barely affected by economic cycles and indirectly benefit from increasing demand in natural resources. Talk about it to a good investment advisor.

Conclusion

Oil and gold are indispensable natural resources. Their price is fixed in US dollars according to supply and demand that varies according to economic cycles, political conditions, climate, etc., in which we have to include the psychology of investors. Greed and fear can move the price of oil and gold to extreme levels.

As companies in this sector don't have a say in the selling price of their raw materials, their profits from previous years often turn into losses in the following ones. Consequently, companies of this sector are cyclical and promote short term investors (speculators). These businesses are very greedy for capital, which takes a bite out of the profits that were meant for the investor. Even on a good day, their profitability is disappointing!

It is not necessary to be present in all the sectors of the economy to get rich. By avoiding the auriferous sector, I missed an opportunity to make money over the last few years, but I also avoided the disaster that is currently happening. I simply prefer to hold on to my investment philosophy and my convictions. My conservative approach has been proven and is used by the greatest investors in the world. It firmly assures my long term objectives.

It would be my pleasure to receive your comments and answer your questions.

Michel Gauthier
Investment Advisor
Tel. 450-462-6395

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[i] Le Monde May 13th 2013
[ii] Giverny Capital 2007
[iii] Fortune Magazine Octobre 2010, Ben Stein
[iv] Warren Buffett. Charlotte Raab La Presse November 3rd 2009