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Investing in Energy Without Getting Shocked

My latest thoughts on energy investment post oil fall: Now that the great oil price shock of ’14/’15 appears to have ended, it’s time to evaluate what it all means for portfolio strategies in energy investment. One obvious point is that the concept of a stable oil price, very much in vogue right up to the time that the prices began to drop, no longer applies–if it ever really did. Another obvious point is that predicting commodity prices is risky business and best left to those who can afford trading losses.

Does this mean that energy is not an industry class that belongs in a prudent asset preservation portfolio allocation? Absolutely not. While there is inherent volatility in commodity prices, not all energy investment is subject to commodity risk. Indeed, much of the capital invested in the energy sector carries little or no commodity risk at all. This is because energy, in all of its many forms, is a capital intensive business and the real assets of the energy industry are typically financed by lenders and equity investors seeking de-risked capital structures, often on a “project finance” risk basis.

Still other investments are fundamentally disconnected from specific moves in crude prices. Vast portions of the petrochemical industry, even the refining of crude into motor fuel, have economics based not on the price of crude but upon the spread between the market of the raw material and the refined products. Many of these business models improved as materials prices fell ahead of the fall in the market prices for the products. And many petrochemical businesses are built upon long-term off-take agreements insulated from market movements. This is true of most liquified natural gas plants as well.

One of the most illogical responses to the drop in oil prices was a general sell-off in renewables. Most US renewable energy generates electricity and so competes with natural gas–which dropped years ago–and coal, not oil. Further, renewables in the US are still heavily a policy driven market, intended to reduce carbon-based fuel consumption, so these businesses often exist in a universe wholly apart from the global crude oil market.

There are also large categories of investments which depend not upon the price of oil but the basic operation of the oil business. For example, midstream oil assets including transportation and storage. Certainly, these assets depend upon the overall continuation of an industry, an existential risk that most investments carry in one form or another. But oil is here to stay, at least for a few more decades, absent some highly unexpected scientific or technological breakthrough. This is a risk best hedged through basic portfolio diversification.

Finally, it is a fair question as to whether energy infrastructure supporting unconventional production, whether midstream or otherwise, is a good bet if crude prices may fall below production costs, as they just did, threatening to idle the whole sub-industry long before a global transition away from carbon-based fuels. Here, there does need to be some thought given to commodity prices. But there is a huge difference between exposure to a risk of sustained oil prices below fully loaded unconventional production costs, say below $60 a barrel, and fretting about an interim drop in prices. In a previous piece on forbes.com, I have written about why prices will recover to at least the $60 to $70 range: http://www.forbes.com/sites/energysource/2015/01/21/why-oil-should-head-up-to-70-in-the-mid-term/ http://www.forbes.com/sites/energysource/2015/01/21/why-oil-should-head-up-to-70-in-the-mid-term/ . Others are even more bullish. Just don't expect a precise date. That is for the commodities traders.

With falling oil mania seemingly over, investors can focus on a wide array of investment targets which may now be available at discounts from the pre-fall prices, whether deserved or not. This was the place to be even as the crude prices were still falling. For those with capital to deploy, here's to hoping that the headline crude price doesn't rise too quickly.