## With the oil price rising, should I invest in an energy fund?

By Claire Fletcher

Since the Unit Trust Corporation launched UTC Energy Fund two months ago, a number of our clients have asked for our opinion of the Fund. Trinidadians have long complained about the distinct lack of energy companies listed on the local stock exchange in spite of the nation's long association with the oil & gas industry.

As the name implies, the UTC Energy Fund, like others pursuing a similar investment objective, allows investors to participate specifically in the booming energy industry. Oil and gas have enjoyed impressive rallies over the past four years, helping energy companies generate considerable profits.

This time last year, oil prices were blasting to an all-time intraday trading high of $78.40 per barrel, and with the U.S. summer driving season in full swing, it's happening again. The black stuff has recently climbed back up to that level and reached a record close of $78.21 a barrel on July 31. Since the beginning of the year, oil prices have risen by 28 percent and show no sign of slowing down.

Unlike the jump last year, the gains on energy markets these last few weeks have not been caused mainly by geopolitical tensions, although these have not disappeared in Iraq, Iran or Venezuela. Rather, the latest surge is the result of tighter market conditions and concerns about insufficient supplies.

As the economies of India, China, etc. continue to grow disproportionately, their demand for energy will continue to increase and supply will become evermore inadequate. Although a global economic slowdown could affect energy prices in the short- to medium-term, shortages are likely to persist in the long run as there simply isn't enough energy readily available to go round.

According to the International Energy Agency, global oil demand will outstrip supply over the next five years, rising by an average 2.2 percent a year between 2007 and 2012. With a global oil supply crunch looming, how much (if any) should ordinary investors have in energy-focused mutual funds?

Most experts recommend between 5 percent and 10 percent of a portfolio. You would think that it would be higher (given a rosy outlook for the sector) but the volatility in this area is so much higher than that of normal funds and an investor typically can't stand that.

Energy funds are sector specific meaning that they must invest entirely or predominantly in the energy sector. They offer advantages over individual stocks by not only providing you the growth of that sector, but also the benefit of automatic diversification within that sector. That way, one bad stock won't ruin your returns. Although most energy funds own dozens if not hundreds of stocks, it is important to know that their holdings are strongly correlated with each other. In other words, they react in a similar manner, either positively or negatively.

Think of a sector fund as magnifying glass. We have all heard about kids who burn ants with a magnifying glass, a cruel but valuable lesson that focus can be a powerful thing. A sector fund has the potential to outperform diversified funds as some industries may respond more favourably to certain economic conditions. Seven of the ten highest returning U.S. stock funds for the year-to-date (as of August 2, 2007) are sector funds, six of which are energy/natural resources funds.

The price of concentration, however, is volatility and while sector investing offers great potential, it also offers great risk. Add this inherent concentration risk to the increased threat of terrorism, geopolitical strife, war and natural disaster, and energy funds become even more volatile. In fact, the standard deviation (the variation of a fund's monthly returns around its average monthly return) of the Morningstar Energy Sector is more than double the S&P 500.

Given the added risks associated with sector investing, it is very important to consider one's risk profile before taking the decision to invest in an energy fund. You need to asses certain criteria that may be important to your profile such as:

- Is your portfolio well-diversified?
- Do you have the capacity and temperament to take on the risks associated with investing in an energy fund?
- Do you have the capacity to hold an energy fund for the long run?

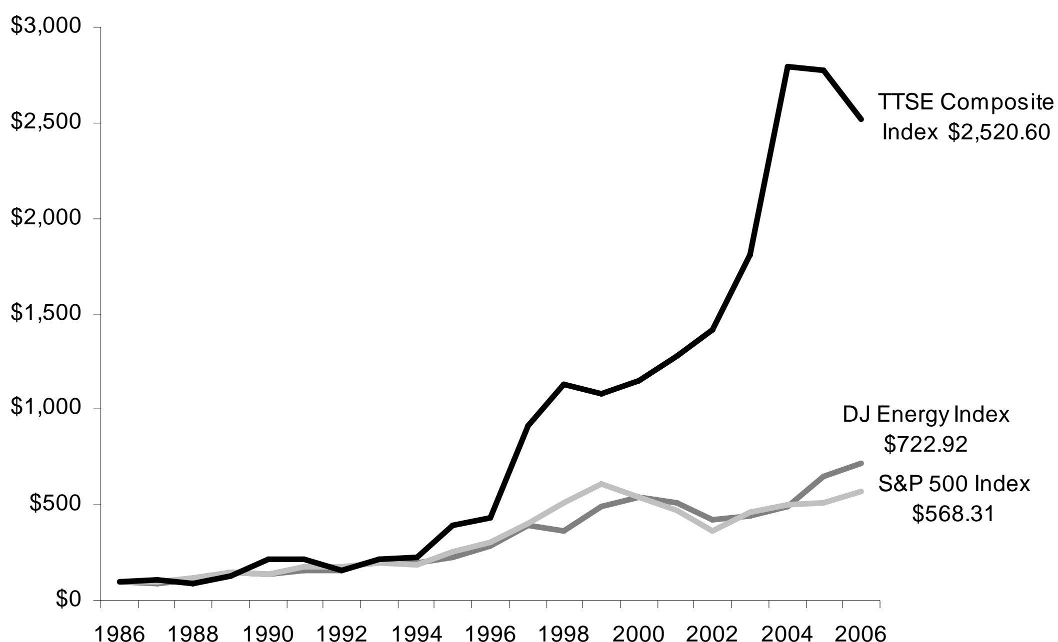
If you can answer "yes" to all of the above, then an energy fund may have a place in your portfolio. Not only can an energy fund add spice to your portfolio, it can also be a decent diversifier too by helping you increase exposure to a sector that may be under-represented in your portfolio. Personally, I believe that a well-diversified portfolio doesn't need sector funds.

If you owned the Fidelity AW International Fund, for example, you'd have all the major world industries covered, including a 9% allocation to energy stocks. Adding an energy fund will only serve to broaden your exposure to an already well-represented sector thus increasing the overall volatility of your portfolio.

It is therefore advisable that you review your portfolio to ensure that you are not in a sector in which you already have sizable exposure through diversified funds. You might even argue that as citizens or residents of an oil-based economy, Trinidadians are already significantly exposed to the price of oil & natural gas.

If an energy development of Internet proportions lead to a dramatic reduction in hydrocarbon demand and the subsequent collapse of oil prices, not only would the economy be forced into a recession, but the money you invested in that energy fund could also disappear.

If despite the risks you still can't resist the temptation to bet on the energy sector, just be sure before buying that energy fund that your investment portfolio is diversified beyond oil and gas and the expected returns from this sector are adequate to compensate you for the risk you are taking.




*Source: Bloomberg*

It is interesting to note that the T&T Stock Exchange Composite Index significantly outperformed the Dow Jones STOXX Energy Index over the past 20 years. If you had invested in the TTSE Composite Index in January 1987 and held it through December 2006, your annualised return would have been 17 percent, 7 percent better than the Energy Index.

If you still believe that the energy sector can beat the broad stock market over the long term, the next step should be to select the right fund. There are several exchange-traded funds (ETFs) specialising in energy stocks such as the Energy Select SPDR fund and the Oil Services HOLDRs fund.

ETFs are perhaps the easiest way to bet on the industry since they are similar to index mutual funds except they trade like stocks. Like index funds, ETFs can only perform as well as the underlying index they track whereas actively managed funds, such as the UTC Energy Fund, have managers who invest with the hopes of beating the benchmark.

While some mutual funds perform better than indices, others under perform, due in part to the type of fund and its manager, so always look for a fund with a strong track record before investing in it. Since energy funds are long-term investments, always look for a fund that has a strong three- to five-year track record compared to its established benchmark.

Don't invest in a fund because it beat its benchmark last month or even last year. It's better to see how a fund performs over the course of a market cycle, preferably five years. That way you get a fairly good idea about whether the energy fund under review has stood the test of time.

Many new fund offers launched over the last few years have done reasonably well leading investors to believe that they are well-managed funds, while the fact is that the markets have appreciated sharply over this period. So a fund manager would have to be really incompetent to lose money over this period. It takes a bear phase to separate the men from the boys.

My advice is to go for existing funds which have been tried and tested. To make money from the energy sector, you must choose a good fund, and evaluating its long-term track record is an essential part of the process.

There are a few mutual funds available which have been in existence for at least five years and have consistently outperformed their benchmark during this time. I particularly like the Investec Global Energy Fund, a Guernsey-based U.S. dollar-denominated fund launched in 1985 and averaging 30% annually over the last five years.

However, like many energy funds, the Investec Global Energy Fund is overwhelmingly in oil assets, giving you little exposure to natural gas, coal, nuclear power or electricity generation. While taking a flier on this or any other energy fund with a very small portion of your assets, say 5 percent, can be very exciting, I caution you to engage in such activities only after you have built a diverse portfolio.

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