Want to Bet on Oil? Don't Buy Oil Companies

Description

It's amazing what a difference a year makes in Canada's oil sands. At this point in 2014 oil was trading for more than US$100 per barrel in the United States. Fears of supply disruptions in Iraq and Russia were gripping the market. Many oil companies' stocks were trading near record highs. All was going right.

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Now, of course, the story is very different. Oil prices have plummeted, as have the profits of companies that produce the stuff. Big projects have been deferred, and rig counts are way down. Stock prices have collapsed, and some companies have gone bankrupt.

But many people think oil prices are due for a rebound. So, what is the best way to make this bet? Ironically, it's not from buying oil companies at all! We take a closer look below.

The problem with oil stocks

Canadian oil companies can be broadly grouped into one of two categories. On the one hand, you've got producers that have poor balance sheets. These firms have been hit the hardest, and their stock prices have absolutely collapsed. Examples include **Penn West Petroleum Ltd.**, whose stock price has fallen by 79% in the past year, and **Lightstream Resources Ltd.**, whose price has fallen by 88%.

These companies offer the most reward if oil prices recover, but they're extremely risky. In fact, there's a possibility of bankruptcy even if oil prices fall just a little bit. Unless you're wagering a very small amount of money, this isn't the best way to bet on a rebound.

On the other side, you've got large, stable producers like **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) and **Canadian Natural Resources Ltd.** (TSX:CNQ)(NYSE:CNQ). These companies are well positioned to survive low oil prices for a long time and, as a result, are far less risky investments. But here's the problem: their shares are pricey.

This should make sense. Portfolio managers across the country have been frantically switching their energy holdings into more stable producers like Suncor. As a result, the energy giant's shares have only fallen by 25% in the past year, much less than oil's fall. CNRL's shares have fallen by about the same amount. Both companies' shares are pricing in a strong oil recovery already. There's little money to be made.

Better alternatives

Luckily, there are a couple of better alternatives.

First, you can buy a company like **Canadian Western Bank** (TSX:CWB). CWB's shares have fallen by 25% in the past year, driven by concerns over oil prices. But energy producers only account for a small portion of the bank's loans. And the oil crisis has yet to make a real dent in CWB's profits. So far this fiscal year, cash earnings per share have actually increased by 4%. Thus, if oil prices rebound at all, there's potential for this stock to rise dramatically.

Another strategy, one endorsed by **Sprott Inc.** portfolio manager Eric Nuttall, is to buy energy service firms. These companies have been battered by reduced drilling activity, but this will turn around if oil prices recover. Better yet, their stock prices tend to spike faster than the energy producers in a bull market. One of his favourites is **Trinidad Drilling Ltd.** (TSX:TDG), which is trading at less than 60% of its tangible book value.

Either way, just because you like a commodity, you don't have to buy the companies that produce it.

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CATEGORY

1. Energy Stocks
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TICKERS GLOBAL

1. NYSE:CNQ (Canadian Natural Resources)
2. NYSE:SU (Suncor Energy Inc.)
3. TSX:CNQ (Canadian Natural Resources Limited)
4. TSX:CWB (Canadian Western Bank)
5. TSX:SU (Suncor Energy Inc.)
6. TSX:TDG (Trinidad Drilling Ltd.)

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