Oil Investors: Don’t Make This Giant Mistake in 2020

Description

The energy sector has been incredibly volatile in recent years. Many companies have gone bankrupt, while others still struggle to survive. Some operators, however, are doing quite well. Cash flow remains strong, dividends are rising, and share buybacks total in the billions of dollars.

In the future, this disparity between rich and poor will continue to grow. If you’re invested in oil and gas stocks, it’s critical to know which side of the equation you’re on. Fortunately, there’s one easy way to determine if your portfolio will end up a winner or a loser.

Avoid upstream producers

This week, Norway revealed that its $1.1 trillion sovereign fund will divest companies solely dedicated to oil and gas exploration and production. “The fund will continue to maintain stakes in refiners and other downstream firms,” reported *Reuters*. “An earlier decision to maintain investments in so-called integrated oil firms…also remains in force.”

This is momentous news. While the move was partially driven by environmental concerns, the biggest driving force was to protect the portfolio from falling oil prices. Over the next few decades, Norway anticipates the price of oil remaining depressed, and even falling, due to reductions in demand. Falling prices will hit exploration and production companies hard given that their profits are directly tied to the price of oil.

Note what Norway’s fund *isn’t* selling. The country is maintaining its investments in refiners, downstream firms, and integrateds. Integrateds is a fancy name for companies that operate across the full value chain, from production and transportation to refining and marketing. Wise investors will follow Norway’s lead and invest accordingly.

How to invest

Rule number one: ditch companies focused on high-cost exploration and production. **Canadian Natural Resources Ltd.**

(TSX:CNQ)(NYSE:CNQ) is a perfect case. While the company is currently touting its free cash flow growth, dividend increases, and sizeable share buybacks, a long-term view negates all of these supposed tailwinds. Since mid-2008, CNQ stock has lost 50% of its value. After 11 years of execution, investors were left with a steep loss.

According to Norway's arguments, this trend should continue, despite what Canadian Natural's management team tries to sell investors. The truth is that we're in a lower-for-longer environment. Production costs are coming down across the board. In the past, only Saudi Arabia could achieve breakeven costs of US$15 or below. Today, several North American projects anticipate breaching these levels.

Canadian Natural, meanwhile, is stuck on the wrong side of the cost curve. Its breakeven cost level is likely close to US$40 per barrel, giving it little breathing room if oil prices dip again. And because oil sands output is at a permanent cost advantage, it won't be making rapid improvements relative to the industry anytime soon. If you're invested in stocks like CNQ, you're fighting a rising tide.

Suncor Energy Inc (TSX:SU)(NYSE:SU) is quite the contrast. While the company is exposed to oil sands production, it also controls its own refineries and pipelines. Suncor is a classic integrated oil company. This approach has several advantages. Refineries typically run counter-cyclical to oil prices, so if oil prices fall, refinery margins rise, offsetting much of the pain. Pipelines, meanwhile, are often completely agnostic to swings in commodity prices given they price on volumes.

Suncor's integrated business model has even attracted the likes of Warren Buffett. Earlier this year, **Berkshire Hathaway Inc.** purchased 10.8 million shares. Norway and Buffett, which control a combined $2 trillion, seem to agree on one thing: bet on integrated operators, not explorers or producers. If you want to succeed in energy investing, I'd heed their advice.

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