XEG: Up 100% in the Last Year, Is This Energy ETF Still a Buy?

Description

The energy sector has been on an absolute tear since March 2020. In the last 22 months, Canada's energy ETF, called **iShares S&P/TSX Capped Energy ETF** (TSX:XEG), is up 317%, easily crushing broader market returns. However, despite these stellar gains, the energy sector has grossly underperformed most other sector indices over the past decade.

But investing in energy companies might still create value, given the expanding global population and a globalized economy, which will drive demand for fossil fuels going forward. Alternatively, the energy sector is cyclical, which increases investment risk during periods of recessions.

In the first half of 2020, the COVID-19 pandemic drastically reduced demand, resulting in an oversupply of crude oil and natural gas. Several oil producers had to cut or entirely suspend dividend payments to combat rising losses and negative cash flows. As economies reopened, the demand for oil gained momentum, which also drove prices to multi-year highs.

The price of oil is the biggest factor that should impact your investment decision. When oil prices rise, companies have the opportunity to benefit from a widening bottom line. An inflationary environment allows energy companies to generate substantial cash flows and support dividend increases. Similarly, falling oil prices will negatively impact the stock prices of energy companies.

The costs of oil exploration, refining, transportation, and storage is fixed. So, if these costs amount to, say, $40/barrel for a company and oil prices are closer to $75/barrel, the oil producer can generate $35/barrel in profits. Similarly, if oil prices fall to $50, the profits per barrel would range at $10.

The XEG ETF provides you access to several companies

The energy sector consists of multiple subsectors. For example, upstream companies explore and produce oil while midstream companies transport, refine, and store commodities. Downstream companies refine crude oil into products, such as petrochemicals, and sell the refined product to customers.

Alternatively, you can also look to invest in ETFs such as the XEG to gain exposure to the energy sector. An ETF is ideal for investors who aim for diversification at a low cost. Generally, ETFs hold a basket of stocks, making it easier for people without expertise to invest in the equity market.

The XEG ETF provides you targeted exposure to companies in Canada's energy sector. It has over $1.6 billion in assets under management and gives investors exposure to 22 stocks. It also offers investors a forward yield of 1.9%, making the ETF attractive to income seekers.

The top holdings of XEG include **Canadian Natural Resources**, **Suncor**, **Cenovus Energy**, **Tourmaline Oil**, and **Imperial Oil**; they account for 73% of the ETF.

The Foolish takeaway

It's extremely essential for investors to understand the volatility that impacts the oil sector. So, it makes sense to focus on companies that have a robust business model, allowing them to derive cash flows across economic cycles.

While I am a huge fan of ETF investing, I don't believe the XEG can consistently outpace ETFs that track the S&P 500 or even the tech sector south of the border. Further, its expense ratio is over 1%, making it quite expensive at current prices.

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Author
araghunath