2 Energy ETFs Are Vulnerable to Dividend Cuts in case of Demand Shocks

Description

The energy sector is volatile but it's a heavyweight on the TSX. If not for the sector's continuing surge, Canada's primary stock exchange would have entered correction territory already. As of February 25, 2022, the year-to-date gain is 24.57%.

For investors who want to simplify the selection process, exchange-traded funds (ETF) specific to the energy sector are available too. BlackRock's **iShares S&P/TSX Capped Energy Index ETF** (TSX:XEG) and **BMO Equal Weight Oil & Gas Index ETF** (TSX:ZEO) are two examples.

However, individual stocks might be safer options today than either income-focused energy fund. Most of the energy companies have been generating significant cash flows due to the favourable pricing environment. Both energy ETFs are dividend-payers, although cuts are possible if demand shocks similar to 2020 happen.

Benchmark 1

BlackRock is the asset manager of iShares S&P/TSX Capped Energy Index ETF, the top-performer so far in 2022. At $13.18 per share (+24.57% year-to-date), XEG pays a 1.81% dividend.

The fund's target exposure is Canada's energy sector. Its investment objective is to deliver long-term capital growth. XEG replicates the performance of the **S&P/TSX Capped Energy Index**. The fund has a high-risk rating and holds 23 energy stocks led by oil majors **Canadian Natural Resources** (26.14%) and **Suncor Energy** (24.15%).

Regarding exposure breakdown, oil & gas exploration & production companies (57.15%) have the higher percentage weight than integrated oil & gas firms (42.17%). The main attraction of XEG is the dividend yield, and therefore, don't expect much on capital appreciation. Still, the current share price is 85.4% higher than a year ago.

Benchmark 2

BMO Equal Weight Oil & Gas Index ETF replicates the performance of the **Solactive Equal Weight Canada Oil & Gas Index**. The fund invests in the oil & gas sector, namely integrated (41.56%), storage & transportation (35.32%), and exploration & production (23.12%) companies.

Like XEG, the risk-rating of ZEO is high. If you invest today, the share price is $55.03 (+18.55% year-to-date), while the dividend yield is 2.8% dividend. While the fund's focus is oil & gas, the asset manager maintains equal weights to lessen security specific risk.

The basket has fewer stocks (nine only) with **Cenovus Energy** as the top holding. ZEO has shares of Canadian Natural Resources and Suncor Energy too because both are integrated oil & gas companies. This ETF also mirrors the performance of the red-hot energy sector. Its current share price is the highest it has reached in 2022.

Alternative mutual fund with ETF

Ninepoint Partners LP recently announced plans to launch a new investment vehicle. Eric Nutall, its senior portfolio manager, said the **Ninepoint Energy Income Fund** will focus on cash-flush energy companies, so it could distribute income to shareholders.

The structure is an alternative mutual fund with ETF series. Nutall believes the multi-year bull market will sustain significantly high oil prices. Investors can also expect energy companies to increase dividends in the coming years. Since most players will reduce debts, the alternative is to return excess cash back to shareholders, he says.

Floodgates might open

Energy ETF investors can't be complacent. XEG and ZEO are excellent dividend plays for now. However, if OPEC decides to increase production and arrest the price surge, oil stocks could tank. Thus, a slash or stop to dividend payments, stocks or ETFs, could ensue.

CATEGORY

1. Energy Stocks
2. Investing

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2. TSX:ZEO (BMO Equal Weight Oil & Gas Index ETF)

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Date
2025/09/27
Date Created
2022/03/01
Author
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