Top Canadian Oil ETFs of 2023

Description

According to the Canadian Association of Petroleum Producers, the Canadian oil industry contributed $105 billion to Canada's Gross Domestic Product (GDP) in 2020 alone and is expected to contribute approximately $8 billion in taxes from 2020 to 2025[1].

Investing in Canadian oil stocks can be a great way of hedging against inflation given their sensitivity to rising commodity prices. A study by the CFA Institute found that one of the few sectors which outperformed during inflationary periods was energy, with oil stocks, in particular, recording the highest historical returns[2].

While Canadians can purchase individual oil stocks, a simpler and more diversified approach might be purchasing a Canadian oil industry exchange-traded fund, or ETF.

But are they the right investment for you? Let's dig in.

What is an oil ETF?

Canadian oil stocks can be separated into three different categories: upstream, midstream, and downstream[4]. The differences are:

1. Upstream: These companies explore oil deposits and extract them for production.
2. Midstream: These companies store, export, and transport oil.
3. Downstream: These companies refine oil into products like gasoline, diesel, and jet fuel.

A Canadian oil ETF will therefore hold a basket of different Canadian oil stocks, either spread out between each of the three segments or concentrated in a particular one.

When investors buy shares of a Canadian oil ETF, they receive proportional exposure to all the underlying oil stocks. This approach requires less money, as you must only buy a single ETF instead of shares of multiple different individual Canadian oil stocks.

Canadian oil ETFs trade on exchanges like stocks do, with their own ticker symbol. Thus, they can be traded daily and have high liquidity.

One benefit of Canadian oil ETFs is the possibility of an increased distribution schedule. While most Canadian oil stocks pay quarterly dividends, some Canadian oil ETFs will pay monthly distributions by aggregating the dividends paid by the underlying stocks. This can be desirable for investors looking for more consistent income.

Top oil ETFs in Canada

The following Canadian ETFs offer exposure to oil sector stocks or futures contracts that track the price of crude oil:

ETF	Inception Date	MER
BMO Equal Weight Oil & Gas Index ETF (TSX:ZEO)	2009-10-20	0.61%
Horizons Crude Oil ETF (TSX:HUC)	2009-06-24	0.89%
Horizons Pipelines & Energy Services Index ETF (TSX:HOG)	2014-07-14	0.64%

Data as of December 6, 2022

BMO Equal Weight Oil & Gas Index ETF

ZEO tracks the Solactive Equal Weight Canada Oil & Gas Index, which holds 11 Canadian oil stocks. The ETF targets an equally weighted allocation, with each stock receiving a 9–11% weighting. Specifically, 39.9% of the ETF is in oil and gas transportation stocks, 30.3% in integrated oil & gas stocks, and 29.8% in oil & gas exploration and production stocks. ZEO pays monthly distributions and as of December 2022 charges a MER of 0.61%.

Horizons Crude Oil ETF

HUC tracks the Solactive Light Sweet Crude Oil Winter MD Rolling Futures Index ER. This ETF does not hold any Canadian oil stocks. Rather, it gains exposure to the price of crude oil by using futures contracts, which are derivatives that bet on the future anticipated value of a commodity. As of December 2022, HUC costs a MER of 0.88% and is best suited for short-term trading or hedging purposes.

Horizons Pipelines & Energy Services Index ETF

HOG tracks the Solactive Pipelines & Energy Services Index, which holds Canadian midstream oil and gas companies, mostly pipelines and energy services companies. Compared to broad energy sector ETFs, HOG has historically lower volatility given that its holdings have fixed service costs. As of December 2022, the ETF costs a MER of 0.65% and pays out distributions on a quarterly basis.

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Types of Canadian oil ETFs

Canadian oil ETFs can either be passive or active when it comes to how they implement their investment strategy and select their underlying holdings. The differences are:

- **Passive ETFs** track a third-party index of Canadian oil stocks with the goal of replicating the index's holdings as closely as possible.
- **Active ETFs** use their own strategies, screeners, and formulas to pick and choose Canadian oil stocks with the goal of outperforming a benchmark.

When it comes to determining how much of each stock a Canadian oil ETF will hold, there are two approaches: market capitalization weighted and equally weighted.

- **Market-cap weighted**: The underlying oil stocks in the ETF are held in proportions relative to their market cap. Thus, large-cap stocks are held in the greatest allocations, followed by mid-caps, and then small-caps.
- **Equally weighted**: The underlying oil stocks are held in equal proportions, regardless of their market capitalizations. Thus, large-cap stocks are held in the exact same weightings as mid- and small-cap stocks.

Like all ETFs, Canadian oil ETFs charge investors an ongoing management expense ratio (MER). This is the percentage fee deducted annually from your investment's gross return. The MER is comprised of the ETF's management fee plus manager's trading, operational, administrative, and marketing costs. For example, a Canadian oil ETF with a MER of 0.50% would cost you around $50 annually for a $10,000 investment. Keeping this as low as possible is always a good idea.

Many Canadian oil stocks are dividend payers, and Canadian oil ETFs are no different. Canadian oil ETFs pay distributions, which can consist of dividends from the underlying stocks, capital gains, or return of capital. Depending on how the distributions are categorized, they can be taxed differently.

Pros of investing in Canadian oil ETFs

The following might be good reasons to invest in Canadian oil ETFs:

- **Hedging inflation**: As noted earlier, oil stocks have historically outperformed other sectors during inflationary periods.
- **Hands-off investing**: Managing a single ETF can be easier than manually trading and rebalancing a portfolio of multiple individual Canadian oil stocks.
- **Monthly dividends**: Canadian oil ETFs often pay higher than average dividends on a monthly basis, which can be desirable for investors seeking consistent income.

Cons of investing in Canadian oil ETFs

The following might be good reasons to not invest in Canadian oil ETFs:

- **Poor diversification**: Canadian oil ETFs only hold a few industry-specific (oil) stocks in a single stock market sector (energy). This can make their performance more sensitive to certain macroeconomic variables and more volatile than a diversified index ETF.
- **High volatility**: Canadian oil ETFs are highly sensitive to commodity prices and cyclical in performance. Downwards fluctuations in crude oil prices can negatively affect the value of Canadian oil ETFs.
- **Higher expense ratios**: Canadian oil ETFs often charge a significantly higher MER than regular index ETFs do. Index ETFs can go as low as 0.04% in Canada, whereas the lowest-cost oil ETF costs 0.61%.
- **Environmental considerations**: Investors who dislike the fossil fuel industry might not like Canadian oil ETFs for moral or ethical reasons.

Are Canadian oil ETFs right for you?

The answer to this question depends on your time horizon, investment objectives, and risk tolerance. In general, an allocation to Canadian oil ETFs is best suited for long-term investors who are prepared to accept long periods of possible underperformance and high volatility.

If your goal is to hedge against high inflation while still earning attractive income, then a Canadian oil ETF might be a good investment. Buying a Canadian oil ETF is easier and offers more diversification than selecting a portfolio of a few individual Canadian oil stocks.

However, prospective investors should note that most Canadian index ETFs already hold a significant allocation of Canadian oil stocks. As noted at the beginning of this article, indexes like the S&P/TSX Capped Composite are heavily concentrated in energy stocks, which includes oil stocks. Adding too much of a Canadian oil ETF can leave an investor excessively exposed to the industry's risks.

TICKERS GLOBAL

1. TSX:HOG (Horizons Pipelines & Energy Services Index ETF)
2. TSX:ZEO (BMO Equal Weight Oil & Gas Index ETF)

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