Legacy Trust

Investment Perspectives

Five Questions About – Fossil Fuel Energy

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Greg Barshied, CFA
Associate Portfolio Manager

Key Takeaways

- Energy has been the best performing sector YTD, outpacing the S&P 500 by ~74% (as measured by XLE - Energy Select SPDR ETF).
- Higher energy prices contribute to inflationary pressures both directly and indirectly – as a component in CPI and forcing producers to navigate higher costs for production and delivery.
- Asset allocators are unsure about what ESG considerations will mean for decision making. Expect investors' decisions about how to approach ESG and implement official framework to evolve over time and play out over a period of decades, rather than years.

Energy commodities and energy-related stocks have significant gains year-to-date in what has otherwise been a challenging first half of the year for investors. Crude pricing has far-reaching consequences for the global economy, particularly as the Fed and other Central Banks are hyper-focused on taming inflation. As long-term investors, we must think about how Environmental, Social, & Governance considerations could affect asset valuation in the long run.

1. To the untrained eye, it appears the energy sector, specifically the fossil fuel industry, has a supply-demand scenario that is leading to significant gains. Is that industry a good place to invest right now? Balancing the global oil market is a complex process with many market participants desiring different outcomes. Today, inputs from both the supply side and the demand side have led to upward price pressure, resulting in WTI Crude trading at $118/ barrel, the highest level since July 2008.

On the supply side, global markets are dealing with a shock from ongoing complications from the Russia-Ukraine war. Russia represented about 10% of the world's crude production and although this capacity is still available, sanctions and reputational risk have made some of that supply unavailable to the US and European Union. Price pressure has only been exacerbated on the demand side- an increase in global mobility as the world has learned to live with Covid, paired with easing China lockdowns.

With Crude rallying sharply, energy has been the best performing sector YTD, outpacing the S&P 500 by ~74% (as measured by XLE - Energy Select SPDR ETF). It's important to remember that this return is coming from a very low base after years of underperformance compared to broader benchmarks. All considered, we would not recommend chasing returns in energy and advise clients to stay disciplined with their investment approach. It isn't instantaneous, but over time, more supply will be brought online and commodity prices will normalize. The futures curve shows an expectation for moderation, with Jan 2023 WTI contracts trading at $103/barrel and Jan 2024 at $87/barrel, with prices settling back in the mid-$60s in the longer run.

2. How does higher energy pricing flow through to other areas of the economy? As investors, we watch crude pricing closely not because we hold the commodity outright in client portfolios, but because of the far-reaching consequences pricing has throughout the global economy.

• Impact on gasoline pricing and potential demand destruction. With today's national average at $4.86/gallon, prices at the pump are beginning to be a pain point for consumers. Consumers begin to reduce fuel consumption when facing high gas prices and opt to stay at home instead of driving whether it's for vacation, to go to the mall, out to eat, or otherwise.

• Higher energy prices contribute to inflationary pressures both directly and indirectly. Energy costs hit the Consumer Price Index directly, but also indirectly as producers navigate higher costs both in production (oil is a key input in manufacturing) and delivery. Corporations then often split the burden with consumers, passing on price increases, with the balance hitting earnings margins.

3. Are ESG policies, which are becoming more prevalent in the corporate world, a cause for concern when considering the oil and gas industry for investment?: As long-term investors, we must think about how ESG could affect asset prices going forward. As global investors make decisions about what role climate change and ESG will play in portfolio construction, there is an argument to be made that Oil & Gas companies may face permanent valuation impairment and thus should trade at a discount to other areas of the market.

The reality is that asset allocators are unsure about what ESG considerations will mean for decision making. In the short run, is the market as a whole going to forgo an investment opportunity based solely on an ESG rating? Market participants will continue to allocate capital to companies with unfavorable ESG ratings if it is the best offering in an opportunity set.

At present, Endowments and Foundations are the asset allocators that are most sensitive to ESG considerations. We expect investors' decisions about how to approach ESG and implement official framework to evolve over time and play out over a period of decades, rather than years.

4. What about non-fossil fuel energy? Is there a renewal or sustainable energy sector that is gaining traction among investors? Wind, hydro, and solar power provide clean energy that accounts for roughly 12% of total U.S. energy consumption and the hope has been and continues to be that it will continue to grow. There are countless benefits to renewables both for the environment and for humanity. Unfortunately, there are problems, with the main one being that despite continued investment in renewables, there is a considerable shortfall to current levels of consumption, which is why we rely on fossil fuels. Renewable energy also requires incredibly high upfront capital outlay and can be unreliable given reliance on wind or sun to harness energy. There are a number of publicly traded renewables companies including NextEra Energy (largest producer of wind and solar), Brookfield Renewable Partners, and many solar companies.

5. Domestic and foreign automakers are putting a great deal of their future R&D in the electric vehicle (EV) space. Does it make sense to look at investment opportunities in that sector? Gas prices provide free marketing for EV companies as consumers watch a growing proportion of their disposable income spent at the pump. There is no doubt that EV adoption is accelerating as more EV makes/models are becoming available, charging station networks expand, and battery range increases. Adoption will take time, with the average car age on the road in the US being 12.2 years.

Investors have several options to play the ongoing boom in EVs- you can gain exposure by buying auto manufacturers, suppliers, companies that focus on charging, or companies that mine for Lithium, a raw material that is a key component in EV batteries. As the industry continues to evolve, there will be significant volatility in EV related investments and it's important that any exposure is part of a broader, well-diversified portfolio. From a manufacturer standpoint, it's hard to say who the ultimate winners will be. At present, Tesla has a significant lead on the field (and is valued as such), with streamlined production and distribution globally, but will face intense competition in the future. Management teams at traditional auto manufacturers know they must evolve and in coming years will have improved products alongside other players like Rivian and Apple.