GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

Why It Is Too Early To Make a Big Sector Bet on the Energy Sector

As a portfolio manager one is always tempted to try to get ahead of market sentiment and invest in sectors that are currently showing extreme signs of pessimism. Most of the times getting in ahead of the pack turns out to be a poor decision or at best one fraught with lots of moments of self-doubt.

While the temptation to invest early and maximize the potential gain from being a contrarian will always be there our research and experience as portfolio managers makes us believe that it is best to follow a systematic approach when dealing with such situations.

Our way of assessing sector opportunities is to rely on structured models incorporating a number of key investment concepts. These concepts form the foundation of our investment beliefs and are directly attributable to the drivers of stock market performance – valuation, growth, profitability, income generation and finally, investor sentiment. Judgment, of course, also plays a role in providing color around our model recommendations and, in our view, the macroeconomic picture is one of excess energy supply. Broadly speaking, global growth is not what investors expected even six months ago and the more secular growth on the supply side has had its expected price depressing effect.

Judging by these metrics it is way too early to take a big position in the energy sector. The rationale for our assessment is simple – energy stocks are simply not cheap enough and both top and bottom-line growth has turned south. Moreover, the generous yields of many energy stocks are at great risk of being cut in the near term. Table 1 highlights our structured industry rankings in terms of these conceptual building blocks of return. Energy stocks rank toward the bottom in terms of valuation, growth and obviously sentiment. The only redeeming quality of energy stocks according to our approach relates to the income delivered to investors, but as dividends are cut to reflect lower profitability and growth this positive attribute of energy stocks is very much at risk.

From a pure technical perspective it is also clear to us that we may be better off waiting to see a bit more blood on the street. Our read on the energy sector is firmly in the “Down Trend” mode of our six stage technical model. Our research demonstrates that stocks in the “Down Trend” stage can do very well given the appropriate macro-economic backdrop. For example in 2009 such stocks were huge market beaters as investors re-assessed the likely bankruptcy of many companies. In early 2015 we do not foresee a macro-economic environment that would suddenly make investors positively re-assess the prospects of energy companies. In fact, we see global growth slowing down compared to last year which will not be conducive to higher energy prices.

Table 1

Developed Market Industry Rankings – January 2015

NAME	TYPE	STATUS	SCORE	OVERALL RANK	RANK 1 WK AGO	RANK 2 WK AGO	RANK 3 WK AGO	RANK 4 WK AGO	RANK 12 WK AGO	RANK VALUE	RANK INCOME	RANK GROWTH	RANK PROFIT	RANK SENT	VOLATILITY	TECHNICAL STAGE
SEMICONDUCTORS & SEMICONDUCTOR EQUIPMENT	INDUSTRY	DEVELOPED	1.9469	1	1	1	1	1	6	11	13	4	2	1	16.91	BRK OUT
RETAILING	INDUSTRY	DEVELOPED	1.49843	2	5	4	4	5	5	1	22	8	11	10	11.77	BRK OUT
PHARMACEUTICALS BIOTECHNOLOGY & LIFE SCIENCES	INDUSTRY	DEVELOPED	1.2359	3	2	2	2	2	1	3	16	14	19	4	11.27	IMPROV
HEALTH CARE EQUIPMENT & SERVICES	INDUSTRY	DEVELOPED	1.03865	4	4	3	3	4	4	6	24	2	15.5	3	10.78	BRK OUT
SOFTWARE & SERVICES	INDUSTRY	DEVELOPED	0.87524	5	3	5	5	3	2	2	23	3	20	8	12.29	BRK OUT
REAL ESTATE	INDUSTRY	DEVELOPED	0.73241	6	6	6	6	7	12	8	4	16	15.5	7	7.44	BRK OUT
TECHNOLOGY HARDWARE & EQUIPMENT	INDUSTRY	DEVELOPED	0.60318	7	7	9	7	6	3	16	17	18	3	2	11.92	BRK OUT
COMMERCIAL & PROFESSIONAL SERVICES	INDUSTRY	DEVELOPED	0.48332	8	8	7	12	9	9	4	8	1	7	17	10.36	DETER
TRANSPORTATION	INDUSTRY	DEVELOPED	0.37006	9	10	8	11	8	11	15	18	11	8	6	10.49	BRK OUT
UTILITIES	INDUSTRY	DEVELOPED	0.26136	10	13	13	13	13	13	17	2	15	6	5	10.23	BRK OUT
HOUSEHOLD & PERSONAL PRODUCTS	INDUSTRY	DEVELOPED	0.15568	11	9	10	9	12	8	5	12	20.5	12	11	8.14	BRK OUT
MEDIA	INDUSTRY	DEVELOPED	0.05171	12	11	11	8	10	10	10	19	10	21	9	11.20	BRK OUT
FOOD BEVERAGE & TOBACCO	INDUSTRY	DEVELOPED	-0.05171	13	12	12	10	11	7	9	7	20.5	18	13	8.61	IMPROV
FOOD & STAPLES RETAILING	INDUSTRY	DEVELOPED	-0.15568	14	15	14	14	14	14	13	10	9	23	12	8.71	BRK OUT
CONSUMER SERVICES	INDUSTRY	DEVELOPED	-0.26136	15	14	15	17	17	15	7	15	12	5	19	8.70	DETER
DIVERSIFIED FINANCIALS	INDUSTRY	DEVELOPED	-0.37006	16	17	16	15	15	16	14	20	24	14	14	11.57	BRK OUT
CONSUMER DURABLES & APPAREL	INDUSTRY	DEVELOPED	-0.48332	17	16	17	16	16	20	12	21	23	22	16	8.72	BRK OUT
CAPITAL GOODS	INDUSTRY	DEVELOPED	-0.60318	18	18	19	18	18	18	18	11	19	9	21	10.11	DETER
INSURANCE	INDUSTRY	DEVELOPED	-0.73241	19	19	20	20	19	19	23	6	7	10	15	9.22	BRK OUT
TELECOMMUNICATION SERVICES	INDUSTRY	DEVELOPED	-0.87524	20	20	18	19	20	17	20	1	17	1	22	9.31	BRK DOWN
MATERIALS	INDUSTRY	DEVELOPED	-1.03865	21	22	22	22	22	21	19	9	13	4	23	10.82	BRK DOWN
AUTOMOBILES & COMPONENTS	INDUSTRY	DEVELOPED	-1.2359	22	21	21	21	21	24	22	14	6	17	20	11.03	DETER
BANKS	INDUSTRY	DEVELOPED	-1.49843	23	23	23	23	23	23	24	5	5	24	18	10.32	BRK DOWN
ENERGY	INDUSTRY	DEVELOPED	-1.9469	24	24	24	24	24	22	21	3	22	13	24	17.83	BRK DOWN

The energy sector, as investors have recently found out, has also seen a dramatic increase in volatility compared to other economic sectors. At the moment the volatility of energy stocks is nearly double that of other industries. High volatility should not be the rationale for avoiding the sector, but from a total portfolio perspective the higher potential risk of the sector should be offset by higher prospective returns.

Given our structured fundamental approach to investing coupled with our experience as portfolio managers we do not see a solid rationale for making big allocations to the energy sector at the moment. The key catalyst in our opinion must be much lower valuations.

Only when valuations come down significantly will the reward to risk be sufficient for investors to take such a stance. However, as we all know, equity markets can disregard fundamentals in the short term and before we embark on an aggressive buying campaign should valuations become attractive we would like to have some company on such a journey in the form of some technical support.

For now, it is best to remain on the sidelines hoping for a more attractive valuation entry point. We are starting to see significant stock picking opportunities within this highly volatile sector, but as a group our recommendation is to remain under-weight in long portfolios and sector neutral in long/short approaches.

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