BLACK GOLD

GUINNESS GLOBAL ENERGY

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The oil sector has experienced a volatile time over the past five years. The price of oil has swung from highs of over $100 per barrel in 2014, to lows of under $30 per barrel in early 2016. It is now back at around $70 per barrel. So, what does the future hold for the oil price and companies in the oil sector?

Rise and fall of black gold

Having enjoyed a sustained period of prices in excess of $100 per barrel, increased new oil production, especially from US shale oil, eventually meant supply overwhelmed demand. The subsequent fall in the oil price after 2014 represented the end of a 14 year 'bull market' for the commodity.

Interestingly, throughout the period of falling prices, oil demand growth remained strong, led by the extraordinary rise of consumption in emerging market economies. It is sometimes forgotten that there are around 6 billion people living in emerging markets aspiring to the living standards of the 1 billion people living in developed markets.

Electric threat

Thinking about oil demand longer term, a threat looms from the political and economic momentum behind the rise of electric vehicles. However, there are two important factors to consider. First, electric vehicles are penetrating a growing market, so even with a rapid uptake, we see the global fleet of gasoline and diesel light vehicles not peaking before the late 2020s.

Second, the reality is that cars and light trucks account for around 26% of global oil usage, with other sources of demand (heavy transportation including air travel; industry; petrochemicals) making up the rest. We expect these other sources of oil demand to grow significantly over the next decade. This points to significant new oil resources being required to keep up with continuing demand growth, well into the 2030s.

While we expect the US oil system to continue to grow well into the next decade, we see other parts of the non-OPEC world struggling to grow, and volatility within OPEC countries could create uncertainty of supply.

Long-term oil price and valuations

Today, we believe OPEC (the intergovernmental organisation that co-ordinates and unifies pertroleum policies) is striving to find a 'goldilocks' scenario for the market where member countries own economies are better satisfied, the world economy is kept stable and production from the rest of the world grows in a controlled manner. The price that achieves this, we think, is around $70 per barrel.

The valuation of companies in the oil sector remain at depressed levels, consistent with the low returns on capital that oil companies have offered in recent years. The positive news is that we have now started on a new upcycle of improving returns, led by vigorous cost-cutting, the cleaning up of balance sheets, and the tailwind of a better oil price. Indeed, free cash flow for many companies in the sector is better today than it was in 2013 (when the oil price averaged over $100).

Current positioning

We have been managing the Guinness Global Energy fund for nearly twenty years. We construct an equally weighted portfolio of thirty positions, choosing energy stocks from across the market capitalisation spectrum. Our investment decisions result from fundamental study of the underlying commodities they are exposed to, together with detailed stock by stock analysis. We remain fully invested and are value investors at heart. And we are pleased to say that our strategy has produced an annualised return of over 10%, since 1998*.

The fund currently maintains a high weighting to improving returns in the energy sector, via a combination of medium to large cap North American, European and Chinese major oil and gas companies. We also have good exposure to US shale oil growth, through ownership of well placed producers, service companies and pipeline companies. Beyond that, we own independent refiners, benefiting from the strong demand environment, and have exposure to emerging market natural gas demand growth.

Today, we see energy equities being valued by the market as if the oil price will average no higher than the mid to high $50 per barrel. Should the 'market implied' oil price recover to $60 per barrel over the next couple of years, then we would see around 25% upside in the portfolio, and more like 55% upside if $70 per barrel becomes the accepted long term oil price.

*Source: Guinness Asset Management, August 2018

- **Invests globally across the market cap spectrum**
- **Co-managed by James Waghorn and Will Riley**
- **Invests in exploration, production and distribution of oil and gas**
- **Equally weighted portfolio of around 35 stocks**

Chelsea Risk Rating	10
Annual Management Charge	0.75%
Ongoing Charges Figure (OCF)	1.24%

THE CHELSEA VIEW

This fund has a very strong and experienced management team and a proven strategy. It is our preferred fund in the specialist energy sector.