Catching the energy-sector rebound without getting burned

Is it finally safe to invest in energy? And how to invest?

Bryan Borzykowski, 4th March 2016

On the last day of February, the price of crude climbed to its highest level since January 6. While it still has a ways to go to be a rebound of any note, no less an authority than Exxon Mobil CEO Rex Tillerson said this week that it expects oil to trade in a range of $40 to $80 per barrel.

And on Thursday, the energy sector turned positive for the year.

Those who want to take advantage of a potential rebound may want to consider getting into the sector now, when stock prices are still depressed. While one can buy energy-related stocks, that's not an approach for the faint of heart, and there may be a cheaper and less risky way to play this sector.

Over the last several years, numerous sector-focused ETFs have come to market, including several energy industry funds. Since ETFs track market indexes, it's not surprising that most energy ETFs have done poorly over the last year.

For instance, the Energy Select Sector SPDR ETF (XLE), the largest energy ETF, with $12 billion in assets, is down 22 percent over the last 12 months and 1.4 percent on the year. Other funds, such as the PowerShares' S&P Small-Cap Energy Portfolio ETF (PSCE) is down much more — 55 percent over the last 12 months and 14 percent since January.

Yet, if someone thinks that oil prices will rebound, owning an ETF is a good way to go, said Aniket Ullal, founder of First Bridge Data, an ETF research firm. It's typically cheaper to own an ETF than a mutual fund, while also offering a diversified basket of stocks and not requiring deep research and ongoing monitoring of individual companies in the energy sector.

Stock picking in a volatile sector can also be difficult for the average investor.

"There was a 122 percent difference between the best- and worst-performing energy stocks in 2015," said Dave Mazza, head of research at SPDR ETFs. "There's a lot of risk with getting a stock pick wrong."

Ticker	Name	1-month (%)	YTD (%)	1-year (%)	Annual fee (%)
XLE	Energy Select SPDR	5.45	0.17	-22.17	0.16
VDE	Vanguard Energy	6.57	0.83	-23.66	0.1
XOP	S&P Exploration & Production	1.24	-7.8	-46.61	0.35
IYE	iShares US Energy	5.73	0.24	-22.73	0.46
OIH	Market Vectors Oil Services	7.05	0	-25.54	0.35

One of the misconceptions around ETFs is that they all track the same indexes. While that may be true for some things — all S&P 500 index ETFs follow the S&P 500 — within sectors, there are usually several ETFs that track different markets. That means that investors can find products that suit their risk-tolerance level and industry view.

In the energy space, there are ETFs that follow only large-cap stocks, such as Exxon Mobil and Chevron. There are others that track small caps, such as Green Plains and Ultra Petroleum, and still others that look at the entire cap universe. There are also funds that hold all energy-related stocks, while others focus solely on oil and gas producers. Each fund rises and falls differently from one another.

For more defensive investors, owning a large-cap fund may be a better way to go, Mazza said. Larger companies tend to be less volatile than smaller ones, and the numbers bear this out. The large-cap XLE is down much less than the SPDR S&P Oil

& Gas Exploration & Production ETF (XOP), which holds small- and mid-cap names, in addition to large-cap ones. It's down 50 percent over the last 12 months and 16.6 percent on the year.

However, if someone can stomach bigger losses, the upside is greater with a small-cap-owning ETF. Smaller companies always get beaten down the most during a downturn, but because they tend to be more growth-oriented, they rise fastest on the rebound.

"It's those mid- and small-cap names that would likely have the best return in a rally," Mazza said. If they are around long enough to enjoy one: One recent analysis from Deloitte predicts that as much as one-third of U.S. oil and gas companies are still on the way to bankruptcy.

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While the average American will likely be more comfortable owning equity-based ETFs, Ullal said savvier investors have another option: the oil futures market.

Owning an ETF such as the United States Oil Fund (USO), which has about $3.8 billion in assets under management, will give you more direct exposure to oil itself and doesn't require taking on company risk.

Going this route, though, is not without unique risks. The ETF doesn't track the spot price of oil, but rather the futures price. When buying futures, you have to worry about contango, which is when the futures price is higher than the spot price. Those two prices must converge when that futures contract is up; if the spot price is still below the futures price, then you'll lose money on the deal.

This phenomenon was explored in a recent *Wall Street Journal* piece that showed the performance of the ETFs tracking the price of oil had done worse than the price of oil itself.

A steeper futures curve has been a feature of the recent oil slump and is a drag on returns. "Many oil exchange-traded products hold or track the nearest-month futures contracts and regularly rebalance into the following month's contracts. If the nearer-term contract costs less than the further-dated one, the rotation involves getting rid of cheaper contracts to buy more expensive ones. The bigger the difference between the two, the more this so-called roll cost drags on performance. When front-month futures cost less than next-month futures, it's known as contango," the *WSJ* explained.

Ideally, you want the futures price to be below the spot price, but that's not what's happening today. The ETF rolls over contracts — no investor ever actually possesses a barrel of oil when a futures contract comes due — so if the market is in contango, it can end up losing money every time a contract has to be renewed.

USO has fallen harder than most large-cap energy ETFs, down about 50 percent over the last 12 months, but it's dropped more in line with funds that track only the oil and gas producers, which is typical, Ullal said. USO is down 15 percent this year. XOP, which tracks the exploration and production companies, is down 46 percent in the past year and 12 percent so far in 2016.

Ticker	Name	1-month ($)	YTD ($)
XLE	Energy Select SPDR	$300M	$722M
VDE	Vanguard Energy	-$428M	-$300M
XOP	S&P Exploration & Production	-$85M	$71.54M
IYE	iShares US Energy	-43.85M	-$18.39M
OIH	Market Vectors Oil Services	-$73M	-$90M

Those interested in energy ETFs need to be mindful of their overall exposure to the sector. If you also own a broad-based fund, then you'll already be holding some energy-sector equities. Most S&P 500-tracking ETFs, for instance, already have about 6.5 percent of their assets in this industry.

Christopher Turnbull, a portfolio manager at the Index House, a Canadian-based investment firm that invests using ETFs, is weary of sector funds. He thinks they're more for speculators than long-term investors.

Essentially, when you buy a sector security, you're taking a view of the market, hoping that it works out, he said. That's hard for anyone, even professionals, to do. He pointed out that in early 2015, Morgan Stanley upgraded its energy-sector weighting to overweight, only to downgrade the sector to market weight later in the year.

"Essentially, they said they made a bad call," he said. "No one, not even Morgan Stanley, can predict the future."

Another risk that is heightened in energy investing right now is dividends: More cuts can be expected from more companies if things don't turn around in a very sharp way, and rapidly. While Exxon Mobil may be able to defend its dividends, even ConocoPhillips made the decision recently to cut its dividend. Energy stocks have been a staple of dividend investors, and the exposure of dividend-paying ETFs to energy stocks can vary widely.

While it's always a risk to bet on a specific sector, if you do think that a rebound is on the way, buying an ETF vs. stock itself might be the more prudent way to go. "If you want to go long or short or rotate between sectors, owning an industry is a fairly popular strategy," Ullal said. "There's a lot to choose from, and it takes less work."

— By Bryan Borzykowski, special to CNBC.com

Graph: CBOE Crude Oil ETF Volatility Index©