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Oil Considerations and Active Management

In 2014, a number of events will go down in history as major, market-moving events. From an economic viewpoint, though, ***perhaps no other event will have a more significant and long-lasting impact than the collapse of oil prices.*** At this time last year, oil was trading well above $100 per barrel. Last week, the price of a barrel of West Texas Intermediate oil traded at less than $50.

Over the years, oil prices have fluctuated. ***The last two major oil price declines were driven by central bank policy errors – monetary contractions which led to global economic recessions.*** During an economic recession, the world economic activity contracts and demand for oil declines. When demand for any commodity contracts, prices decline. The current oil price decline is not accompanied by an economic growth contraction. It's the first of this type of decline the world has seen in many decades. ***The current oil price decline isn't being driven by a decline in demand, instead it's being driven by an increase in supply.***

With technological advancements, oil can now be coaxed out of the ground. The amount of oil which can be squeezed from rock shale deposits is stunning. Oil production in the United States and Canada is now outstripping production in Saudi Arabia. Last year, when the Saudi's announced they were not cutting production to "defend" prices, market activity moved oil prices downward.

Long-Lasting Change

Technological changes tend to be long-lasting and ongoing. "Moore's Law" refers to the computer industry and states that the number of transistors in an integrated circuit doubles very two years. We've seen massive efficiency and productivity improvements in the computers we use. Once made, ***changes driven by technological advancements --irrespective of the industry -- tend to continue***.

Fracking activities (forcing water/chemicals into the ground to push oil to the surface) is a technology-driven process not broadly known or used in the past. ***Fracking techniques will probably continue to develop, driving oil production costs even lower.*** This isn't to say the cyclical nature of oil prices has changed. It means the ***cost of oil production, and the amount of recoverable oil, will not be the same in the future as it has in the past.***

These changes are nothing new. They represent the latest cyclical "bust" in oil prices, continuing the long-wave cycle of booms and busts the industry experienced in the past. Two questions we consistently receive are:

1. ***How low will oil prices go?*** We don't know the answer to this question, and neither does anyone else (except perhaps for the Saudis). When someone states oil prices will bottom at "X" or "Y", simply nod and say nothing.
2. ***When will oil prices rise back to their old highs?*** Again, we don't know and neither does anyone else***. What we do know is when booms become busts, the "bust" tends to last longer than most anticipate***. Think about the technology bust from 1999-2000. Fourteen years after that bust, tech stock issuance is certainly robust, but not near what it was prior to 1999. Consider the housing bust of 2008-2009…prices in many markets have yet to reach their old highs.

Oil consumption goes hand-in-hand with economic growth. Let's put aside speculation on forecasted oil price changes and focus on what we suspect will happen to the world's economy based on what has already happened in the oil patch.

Economic Impact of $50 Oil Price

Let's do some quick math. The world's annual Global Economic Output (GDP) was $69 trillion as of last summer. According to the *Oil Market Intelligence* report, the world's consumers of oil bought $3.8 trillion (when prices were at $100 per barrel) of oil to produce that $75 trillion of economic output. With oil at $50 per barrel, that same production can occur with an energy "cost" of $1.9 trillion. This represents a production "savings" of $1.9 trillion, or 2.73 percent of global GDP.

Now, this isn't to say that global GDP will be 2.73 percent higher due to the oil price decline, but rather the economic growth of nations consuming ***oil will benefit mightily at the expense of oil-producing nations.*** According to Dr. Ed Yardeni (Yardeni Research, Inc.), the economic "benefit" of the current price decline should accrue at a $915 billion rate to the world's "developed" economies (U.S., Europe and Japan) and at a $990 billion rate to the world's "emerging" economies. The world's "developed" economies create 57 percent of overall global GDP output whereas "emerging" economies produce 43 percent of economic output. With 52 percent of the price-decline benefit accruing to 43 percent of the world, the "emerging" economies should be more substantial beneficiaries of the oil price-decline than their more mature "developed" cousins.

A number of oil-producing countries are counted in the "emerging" market space. However, many smaller countries are major benefactors of falling oil prices. South Korea is a prime example. For every sustainable $10 per barrel price decline in oil, South Korea's economic output could rise by 0.25 percent. Consequently, if oil prices stay at an average of $50 per barrel over the next year, South Korea's GDP output could be 1.25 percent higher than would have otherwise been the case. The same type of analysis holds true for most economies in Southeast Asia.

An oil price decline of this magnitude isn't a "one-way" positive for many economies. Segments of our domestic economy will struggle. Capital spending growth will be stunted. Segments of the high-yield fixed income market will struggle. Consumers, though, will experience an increase in disposable income as gasoline prices decline. Remember, the average U.S. family spends 4 percent of their income on gasoline. The "bonus" of falling gasoline prices (and heating oil, and natural gas) should provide stimulus to overall consumption patterns in 2015.

Longer-Term Considerations

The last two major declines in oil prices were driven by cyclical economic contractions. Demand declines during economic contractions. The current price decline is different because it is being driven ***by excess supply rather than deterioration in demand. The rise in oil supplies has not been driven by a "discovery" of more oil, but rather by technological advancements which have made a rise in oil production economically feasible. It is always dangerous to make the statement that "this time it's different", but this time appears to indeed be different.***

Will OPEC carry as much economic clout globally as it has in the past? Perhaps not. Will oil prices move back above $100 per barrel? Probably…eventually. We don't know the answer to these questions. ***We DO know oil demand will rise as the global economy grows. Oil investments, while currently out of favor, will return to favor. It is just a matter of time and price.***

Active vs. Passive Management

I've been in the professional investment management business for 35 years, entering the business in 1979. I have consistently been a proponent for "active" management – in most portfolio applications. "Passive" investing is investing capital directly into an asset class index and being happy with that money performing in-line with the chosen replicated "index." "Active" investment practice is the more traditional, "stock-pickers" process of attempting to outperform a given index return.

Many in the industry have made strong arguments in favor of "indexation" investing. Those arguments have primarily been driven by cost and potential tax savings. Additionally, again depending on the asset class itself, there have been long stretches when "active" managers have struggled to outperform their underlying "bogey" or index.

Barron's magazine recently published an article highlighting the fact that while the S&P 500 index generated a return of 13.7 percent this past year, only 19.9 percent of "active" managed U.S. equity funds outperformed the index. This underperformance problem has haunted the majority of active managers.

From 1962 until 1983, "active" large-capitalization managers outperformed the S&P 500 by 70 percent. Over this long period of time, interest rates rose from 3.8 percent to 15.8 percent. In addition, over this same period of time there was a reasonably high level of variation of stock returns within the index. ***Since 1983, interest rates have declined and index funds have had their way with "active" managed funds, outperforming the average "active" large-cap fund by a cumulative 84 percent. This represents an average annual level of underperformance to the index of 1.9 percent***.

Why has this level of underperformance occurred? As noted above, over long periods, when interest rates have risen, "active" managers have outperformed relevant indexes. When interest rates fall, index funds tend to outperform. ***There are fundamental reasons behind this long-term trend. "Active" managers tend to favor smaller growth-oriented companies in their portfolios. Observe the average large-cap stock fund and you will tend to find that the fund's average "capitalization", or size of company in the fund, is probably smaller than the average "capitalization" of stocks in the index.***

In addition to the "size" bias of the passive/active argument, ***smaller cap companies tend to use bond market financing less than their large-cap cousins. This makes these company's income statements less sensitive to interest rate changes than large-cap companies. This helps explain why, over long periods of time, small cap companies tend to outperform large cap during times of rising interest rates. If an investor believes interest rates will rise over an***

extended period of time, active managers may move back in vogue as historically they have tended to outperform indexes during periods of rising interest rates.

Volatility

In order to outperform static indexes, active managers need the systemic “opportunity” to do so. During times when the stock market is not particularly volatile, inefficiencies in pricing are rarer than during periods of higher volatility. Volatility leads to price corrections, which lead to asset mispricing. Asset mispricing leads to the ability for active managers to outperform relevant indexes.

As was stated in our 2015 Annual Outlook, we believe price volatility will increase during 2015 as compared to the very “calm” market periods we’ve seen over the last two years. If we are correct on our assessment, we expect active managers to have a more fertile field in which to provide outperformance relative to indexes.

Lastly, headlines are currently announcing the “death” of active management. We usually see these headlines when active managers start to outperform.

We will be back next week.

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