CREDO WEALTH

Step in, and out

Never be a forced buyer. Never be a forced seller. Patience, the ability to walk away, and the behavioural intelligence of learning to pick your battles, is rewarded over the long term.

Commodities are the simplest, and clearest, example of the dance of supply and demand. Commodities like oil don't change. The businesses around them do, as they respond to the needs of people and other businesses. Price is not an indication of permanent intrinsic value. Price is a clearing mechanism. The more supply there is of something, without more demand, the lower the price will be. The more demand there is, without more supply, the higher the price will be. If you are able to look through the cycles, opportunities exist to carefully step in, and out. Not blindly. We remain bottom up stock-pickers who view ourselves primarily as part owners of whole businesses. Whole businesses which operate in a dynamic world underpinned by commodities which don't change much at all.

In early 2015, we bought some oil services companies (e.g. Halliburton) which provide technical products and services for the exploration of new wells. The oil price had fallen by over 50% from highs of over $100/bbl. in mid-2014, to below $50/bbl. There was a supply glut, about 80% of which we attributed to shale oil growth in the USA. We believed the oil services companies would be the first to benefit as rising oil prices would increase expectations for a recovery in oil and gas exploration spending by the majors.

Shale is amongst the highest cost sources of supply, and has much steeper decline rates than conventional oil. Decline rates measure how fast production slows over time. A shale well declines by about 80% in the first 3 years, whereas that would take a conventional well around 11 years. We expected that the downturn in the oil price would result in fewer new wells being drilled (both in the USA and around the world). This is because returns generated would no longer be as attractive at the lower price. Fewer new wells and the shorter lives of the old ones, would result in a significant reduction in supply despite demand continuing to steadily increase. Therefore, we believed that the downturn in the oil price would be cyclical rather than structural, and the supply demand imbalance would be shorter lived than previous supply gluts. This trend played out.

The resultant price appreciation of the oil services companies relative to the oil majors meant that in early 2017, we found better value in selling Halliburton, and buying Shell. The oil price has now increased (around $80/bbl.). Shale production rates in the USA have fallen, and OPEC, in conjunction with Russia and other producers have committed to supply curbs. As a result, valuations of the oil majors have increased substantially.

Therefore, we believe that the risk/reward trade-off no longer justifies being significantly overweight in the sector and have reduced our exposure as a result. Our ability to step in, and out, and our long-term perspective, has proved invaluable on this occasion.

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