

Energy Investing, Forecasting & the Future

The Value of Hard Work and Humility

After 25 years on a waiting list, my father's family immigrated to the US from the shattered remnants of post WWII Europe. Arriving here as a 13 year old, my dad would quickly go from not being able to speak English to attending one of America's most prestigious universities. As time went on he would gather advanced degrees and work tirelessly for a unique nonprofit to help bring cutting edge engineering solutions to the US military.

Having appropriately flattered my father let me get to the actual point. **His brilliance and kindness are only matched by his obdurate insistence on doing everything the hard way.** Faced with housing his family he bought some land, cut down a lot of trees and built a house...on the nights and weekends. Growing up in a family where "a restful weekend" typically involved a chainsaw, tractor and a fair bit of dangerous labor has left me with some odd hobbies.

I always look forward to visiting the home my father built and raised me in. My dad and I still work shoulder to shoulder on many weekends. The smell of diesel exhaust pouring out of our Kubota tractor and the sound of a chainsaw running full tilt brings a grin to my face. I know I am home. **In my life, hard work and burning fuel are directly related to productivity and progress.**

Today the world is awash in stories about "wealth without work." This is not a new thing. It is a recurring theme of speculative manias that dot human history more-often than one might believe.

Look at the list of names trading at valuations far above those seen at the peak of the dot.com bubble highlighted in this [one pager](#). The market is, once again, creating the illusion of wealth as investors pile into firms that race higher despite dubious business models. Markets intermittently succumb to these bouts of reckless speculation. And markets are doing it again. It will end the same as it always has. **If there was a way to give everyone everything without consequences or effort we believe the world would have done it.** Yield Curve Control – where the Fed just prints money with the explicit goal of holding borrowing rates down and other policies will only increase the possibility of the inflation we discussed as a major risk to investors [here](#).

Let's work with the historically proven assertion that, nobody can forecast the future with any accuracy or reliability¹. As Buffett is fond of saying "*Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.*" This view also happens to be held by living investment legend Seth Klarman. As we will share in our upcoming learning piece on his timeless book *Margin of Safety, Risk-Averse Value Investing Strategies for the Thoughtful Investor*, his skepticism of forecasting the future is founded on the bedrock of thoughtful humility.

Yet where do markets price the world's makers of energy today? In the enthusiasm for ESG, markets have forgotten: we simply are not there yet. **Tesla alone is worth almost as much as the entire energy sector in the S&P.** As the Houston Chronical recently documented [here](#) (hat tip DM!), E&P companies are scrapping rigs with 30++ year operational lives when they are only 10 years old. We are not energy experts but we simply cannot recall that happening on this scale. In fact – we're not sure we've seen quite this much supply destruction in the energy sector in such a short period of time.

The ESG movement is good for the world and a huge thematic trend. The beneficiaries in the battery electric vehicle space and many others have seen outsized returns. They may continue to do so. But we think it might also be creating the perfect storm for oil. Everyone is dumping energy as an asset class. Many OECD countries are [withdrawing](#), or contemplating withdrawing, billions in subsidies for oil and gas projects which simply means hurdle rates for projects are only going higher. This tremendous supply constraint is happening right in front of the most cash rich consumer in US history. A consumer we believe is hell-bent on seeing family, friends and going on vacations which could create a tremendous increase in demand for oil.

¹ If you would like the evidence behind this let us know
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We encourage you to read the [recent quarter from XOM](#). After burning cash for 9 straight quarters XOM is back in the black. Paying down debt. Reducing costs. Reducing capex. Deep water production now generates a 10% return....at \$35 oil². Chemicals are shattering profit records. Shale costs are down 40%. At 15x forward earnings XOM doesn't look "dirt cheap" but what price deck is being used to get those numbers? Does it contemplate the massive cost reductions? **What if oil prices were to rise?**

In mid-2019 XOM was at \$80/share despite burning cash, adding leverage and oil was right where it is today. The stock is now at \$58, costs have been slashed, capex tamped down, profitability exploding, debt being reduced and the dividend covered.

If oil companies continue these capital allocation policies of debt reduction it will reduce fear and bring higher multiples. This is at the core of our two white papers on the power of debt reduction and its impact on stock valuations. The papers were titled Activism Lite [Part I](#) and [Part II](#). Reducing leverage is a massive source of alpha and the more "value" embedded in the stock the more bang you get from multiple expansion.

Tarred and feathered by the shale collapse and destruction of junk bond-holders in the space, High Yield is making capital for these investments expensive.³ This is one of the few **places** where capital is scarce or highly valued today.

In the figure below we provide the five highest ranked energy companies in our S&P 500 and Small & Mid Cap models. You will note – XOM is not among them! We use that stock merely to make the broader case that today is a compelling time to be doing some work on one of the least-liked sectors in the market. **For those bearish on energy, we strongly encourage even the most confident forecasters to contemplate "what if my view of the future is wrong?"**

Said differently: we think all someone needs to be interested in our list of energy companies is a bit of financial prudence and some common sense.

Top 5 Ranked Energy Stocks in the S&P500 and Small & Mid Cap Universe

S&P500			Small & Mid Cap		
Kailash Agg Rank	Ticker	Company Name	Kailash Agg Rank	Ticker	Company Name
107	HAL	HALLIBURTON CO	5	OII	OCEANEERING INTERNATIONAL
117	BKR	BAKER HUGHES CO	7	FTI	TECHNIPFMC PLC
164	OXY	OCCIDENTAL PETROLEUM CORP	16	VTOL	BRISTOW GROUP INC
179	SLB	SCHLUMBERGER LTD	28	INT	WORLD FUEL SERVICES CORP
188	COP	CONOCOPHILLIPS	49	STNG	SCORPIO TANKERS INC

Source: Kailash Capital, LLC; Data from 4/30/2021

How our research platform can help you:

No matter if you are a bear or bull the history books are unambiguous: buying high quality cash-generating businesses at fair to low prices is a terrific way to compound wealth. Today's market is a highly bifurcated one. Part of the market is trading at obscene multiples as government subsidized capital, weak covenants from lenders and a speculative mania drive some stocks to absurd prices. **The good news is that in these manic times there are pockets of opportunity that we believe, held over the long haul, will provide far better returns than those available in fixed income.**

² Bloomberg News

³ Hat-tip to Dave B., one of the most seasoned and accomplished High-Yield investors we have the good fortune to know.

Kailash's newsletters and investment tools are committed to helping people interested in compounding capital using the most time-tested methods we know of. Good companies, good managements and good businesses purchased at reasonable prices. You can find them on our [website](#) or by contacting us [here](#). To learn about and gain access to our powerful tools built using research proven out in practice and academia please:

- Click [here](#) for our paper explaining our Stock Ranking Tools
- Click [here](#) for our research explaining how to identify firms manipulating earnings to fool investors
- Click [here](#) for our research on some of the pitfalls faced by investors in index funds

For those of you unfamiliar with Kailash, we believe our organization provides cutting edge, thought-driven, investment analysis tools at prices others simply cannot match. Our research staff has been together for over a decade and has well over 100 years of experience. The team includes proven veterans in the investment management business and one of the most prominent academics in the field of behavioral finance. Our services bring the best of breed quantamental tools and themes to your doorstep.



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