

## There Will Be Blood

Paul: Are you Daniel Plainview?  
 Daniel: Yes. What can I do for you?  
 Paul: You look for oil.  
 Daniel: That's right.  
 Paul: What do you pay for a place that has it?  
 Daniel: That depends.  
 Paul: What does it depend on?  
 Daniel: On a lot of things.

Paul Sunday & Daniel Plainview – *There Will Be Blood* (2007)



The financial system has been rocked in more ways than one in the early part of 2020.

The market in which we have seen the wildest swings has undoubtedly been oil, leaving investors wondering what has left it particularly exposed to the current crisis, the mechanics of investing in oil in general, and what the future holds for the commodity formerly known as ‘liquid gold’.

### In crude terms, what has happened?

Significant price moves in oil are by no means a new phenomenon, albeit usually spread over more than a single trading session.

At the turn of the Millennium WTI spot (the price of physical, can touch it, oil) was priced around \$25 per barrel. Then, due to a dramatic change in demand dynamics, led by an oil hungry, growing Chinese economic powerhouse, exploded to around \$140 in 2008. The widely held consensus at this point was that the only way was up for this finite resource. The Global Financial Crisis promptly put paid to that theory, sending oil crashing back down, before a recovery to over \$100 by 2011, where it remained fairly rangebound, at least by today’s standards, until 2014.

Just as China had dramatically shifted demand dynamics in the noughties, by 2014 the oil landscape had changed significantly on the supply side too; OPEC had long since become worried about the US’ increased shale production and the effect this would likely have on the oil world order, and OPEC members’ place in it, moving forward.

With this in mind OPEC decided to combat the US shale boom by launching a price war, flooding the market with oil and depressing the price, a problem for US shale due to the higher breakeven cost of producers – OPEC were and are attempting to run US shale out of town. Cue a very sharp drop in the price of oil, from which it has never truly recovered, as the war has never truly ended.

Enter 2020 – while previous shocks have tended to be either demand or supply driven, the combination of demand destruction brought on by Covid-19 as well as a renewal of the price war between OPEC, Russia and the United States has made this round of oil price volatility truly unprecedented.

That potent combination sent oil plummeting over February and March, before a tweet from the US President, suggesting that a deal to cut production by 10m barrels per day was imminent, sent the price skyward 30% in a day. A production cut, all 10m barrels per day that was suggested, was agreed, but the price fell again on the back of the realisation that estimates of the demand shock were at 20m barrels per day. (There was still 10m too many barrels being produced per day)

Then, on Monday April 20<sup>th</sup>, the oil price dropped into negative territory.

## How can oil go negative?

Up until this point, many believed that negative oil prices were an impossibility. However, we were now into the realms of the fundamental structural make up and mechanics of the market being tested.

The simultaneous combination of oversupply and destruction of demand that had characterised 2020 to this point led to the world literally running out of space to store oil, and therefore storing had never been more expensive.

We now come onto the mechanics of how one tends to invest in oil.

The majority of participants in the market will access oil through futures; a contract stipulating that one will pay \$x per barrel for delivery on a certain date in the future. This allows producers and consumers of oil to hedge against price movement, and allows investors and speculators to try to profit from them. The futures price does not equal the spot price.

The 'front month future' i.e. that closest to expiry, at which point the holder is delivered the oil, will be priced closest to the actual spot price of physical oil. In normal market conditions one would expect the futures curve to be upward sloping (known as contango) i.e. it costs a little more for each additional month you lock in the price for – this makes sense as you are effectively transferring the cost of storage to somebody else; if this is charged on a monthly basis, then the further out on the curve, the more months of storage you are paying for.

For investors, who don't actually want to take delivery of the oil, they will need to sell their futures contract before expiry; in normal market conditions not a problem, someone will want the oil. However, when storage space runs out to the point that it costs considerably more to transport and store the oil (especially in the case of land-locked WTI) than it would possibly be worth, we enter an environment where the holders of the WTI future about to expire last week were willing to **PAY** \$35 per barrel purely to not have to take actual delivery.

This sums up 2020.

## What an entry point! I'm buying. How can I do it?

*'Ladies and gentlemen, if I say I'm an oil man, you will agree.'* Daniel Plainview – *There Will Be Blood* (2007)

The obvious answer would be to buy an oil ETF – and many have; ownership of the United States Oil Fund (USO), the biggest oil Exchange Traded Product in the world, is up 500% month on month on trading platform Robinhood. Retail investors are piling in.

USO is 'designed to track the daily price movements of West Texas Intermediate ("WTI") light, sweet crude oil.' These words are taken directly from the USO website.

HOWEVER, herein lies the issue on how investors, including ETFs, access oil – by buying futures.

There is ordinarily an upward slope to the futures curve to reflect the cost of storage. It would therefore make sense that as the cost of storage increases, so too does the steepness of the curve i.e. the difference in price between the June future, July future etc etc.

The curve has never been steeper (known as supercontango); there has never been more of a difference in price between the contracts as one goes further out into the future.

This is especially important when considering an oil ETF.

As the ETF, and therefore in effect the investor, will not be taking physical delivery, the front month future will be sold before expiry, and the next month future purchased (depending on the roll mechanics of each individual ETF).

On the chart below, we can see the effect of this:



Source: Fortem Capital, Bloomberg

If the June contract were expiring in the next few days, in order to avoid delivery while maintaining exposure, the ETF must 'pay-to-play' by selling June and buying July - a loss of \$5.26, and as long as the curve remains this shape, it will take a similar loss on each roll, each month. If this loss is greater than any corresponding increase in the front month contract it holds over the month, the ETF will lose money even as the oil price increases – this current figure corresponds to a 43% increase in the front month future before you would actually make any money!

Incidentally, this 'cost of carry', even in more normal times, is why oil ETFs are notoriously poor at tracking the spot price of oil:



Source: Fortem Capital, Bloomberg - Data from 01/01/2015 – 31/12/2019

This constant bleed is why the United States Oil Fund (USO) was trading at \$2.50 early this week, when oil was trading closer to \$20 per barrel, having begun its life priced the same.

On Tuesday April 28, they announced a 1 for 8 stock split i.e. replaced investors' 8 shares of \$2.50 with a new share valued at \$20; this makes the product look more like it is tracking oil, as it is now priced roughly the same as a barrel – do not be fooled.

*Ladies and gentlemen if I say I'm an oil tracker, you will not agree.*

## But surely there is some way to profit from all this? More than one...

### Commodity Curve Strategy:

If the curve is upward sloping, there is a negative yield to the holder of a futures contract as it 'rolls down the curve' towards expiry. However, as can be seen from the previous charts, steepness of this negative 'roll down' is not equal between contracts.

If one were to be short the contract with the most negative roll yield, and long the contract with the least negative roll yield, the difference between them (which has never been more) can be harvested, while insulating the strategy from parallel shifts in the curve as a whole.



10 yr Summary Returns <sup>2</sup>	
Average returns	7.36%
Average volatility	6.21%
Sharpe Ratio	1.18
Correlations <sup>2</sup>	
MSCI World Net Total Return Index	-0.13
Bloomberg Barclays Global Aggregate Index	0.06
Bloomberg Commodity Index	-0.53

<sup>1</sup> 31/03/2010 to 31/03/2020

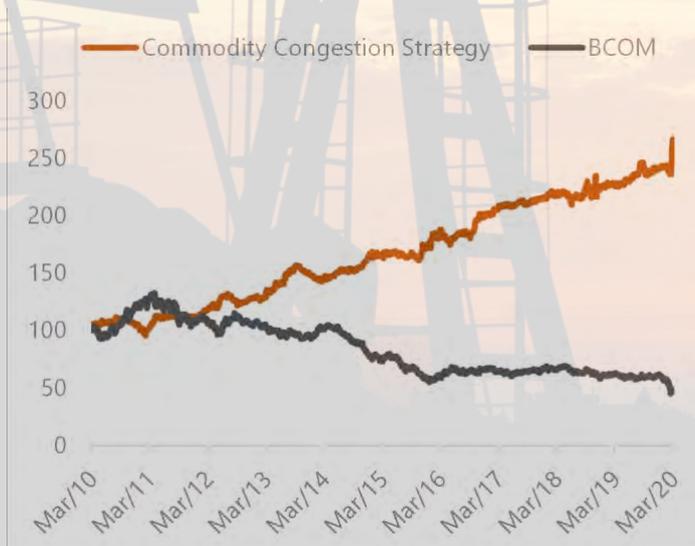
<sup>2</sup> 31/03/2010 to 31/03/2020 – Observed Daily

BCOM – Bloomberg Commodity Index

**SIMULATED PAST PERFORMANCE:** Past performance data shown in this communication includes performance data derived from back-testing simulations. This is provided for illustrative purposes only. Details of the index methodology are available on request.

### Commodity Congestion Strategy:

As discussed, oil (and other commodity) ETFs must roll their futures contracts in order to not take physical delivery. They do this on pre-defined dates. The very act of selling the front month future will put downward price pressure on it, and similarly buying further out put upward price pressure on that contract. One can trade ahead of this process, shorting the front month, and going long further out in order to profit from the phenomena, while again not taking on overall long exposure to oil.



10 yr Summary Returns <sup>2</sup>	
Average returns	10.12%
Average volatility	7.78%
Sharpe Ratio	1.29
Correlations <sup>2</sup>	
MSCI World Net Total Return Index	-0.01
Bloomberg Barclays Global Aggregate Index	0.03
Bloomberg Commodity Index	-0.16

<sup>1</sup> 31/03/2010 to 31/03/2020

<sup>2</sup> 31/03/2010 to 31/03/2020 – Observed Daily

BCOM – Bloomberg Commodity Index

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## And is anybody doing this?

At Fortem Capital, we employ both strategies, amongst other structurally uncorrelated strategies, in the Fortem Capital Alternative Growth Fund as well as in the Diversifier Portfolio of the Fortem Capital Progressive Growth Fund.

Both funds have enjoyed an outstanding start to the year when compared to their peers.

Please do not hesitate to contact the team for more information.

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