



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Oil & Co.

(Part One) Oil is a major investment object and is held in many private and institutional portfolios. It also represents – despite the much rhetoric about alternative energies – the main global commodity, due to its direct role in transportation, heating and energy production, as well as in manufacturing of a widest range of products of any kinds. Moreover it is the object of impressive daily tradings by entities which are directly dependant on it and its by-products, such as oil and energy companies, air carriers, providers of services and so on. But first of all oil is the most relevant commodity from political and strategic points of view. All of that makes crude oil one of the major actors within the financial markets, and its prices are closely monitored and interpreted by analysts, operators and investors.

There are two main quotes for crude oil: the Brent price, referring to the European production, mainly coming from the North Sea, and the WTI, which in the USA accounts for the products of extra-European origins. Oil price is denominated in USD per barrel, being the latter just a bit below 159 liters of capacity, and taking its name from the classical cylindrical metal container universally used for liquid fuels.

Thus crude oil is an absolutely unique item, more than just a commodity, and its quote is the result of many elements, coming from three different sides at least: economic, technical-logistical and geopolitical factors, all contribute in pricing it. The first ones relate to the supply and demand trends, as is the case for any other products. For oil the supply curve is pretty stable, while the demand is increasing. The flattening in supply levels is due to the limited investments in research and innovation following the severe credit crunch while, despite the prevailing gloomy economic scenario, the rationalizations and saving in consumes and the increasing use of alternative energy sources, the demand is increasing steadily, particularly from the still briskly growing Asian countries. Technical factors are linked to the levels of reserves and their spare capacities, which are facing downtrends in a not far future, despite the many known fields which however cannot be exploited due to economic (excessive costs of extraction) or technical reasons, because of their oil quality and the costly and complex processes their treatments would require. There are also bottlenecks with which the oil market is often confronted, as limitations in coastal facilities and refineries, available tankers, logistic problems with pipelines and oilfields in general. *(to be continued) - GLT*

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(Part Two) We have discussed some main features of this commodity, also pointing to the economic, technical-logistical and geopolitical factors affecting its price. Before considering crude oil from an investor's perspective, that is as a major actor of the commodity asset class, we wish to turn to another face of its market. Oil is the object of wide and complex trading activities at international levels, networks of financial transactions linked to its commerce, from digging until selling crude-derived finished products. Oil companies and many other types of institutions operating in oil services, transportation, refining and transforming, as well as its users, all of them act in trading, thus buying and selling it in the forms of crude, refined substances, derived products and so on, in order to secure regular and timely flows, and get financial profits from such transactions. Buying at low prices and selling at higher ones is the goal of the traders, who use nets of counterparts. Such dealings may, for example, even take the bulk of a tanker just leaving the Persian Gulf to change its ownership and destination many times during its sea journey, according to the different weights of supply and demand, as well the search for maximized returns. The trading activity has many sides, concerning crude oil, semi-finished and finished products, as gasoline, gasoil, or sub products to be used in plastic and chemical industries: when it considers relatively short time deliveries, less or around one month, well identified and already available items, during their transportation or under refining, those are then the objects of spot markets. If during the time between the crude buying and its delivery to a refinery the market price increase, that is good news and the trader is satisfied, but if the price trend for refined products is on the downside at delivery, a problem arises for the trader as he faces a loss. *(to be continued) - GLT*

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(Part Three) The traders of oil companies and related businesses engage in complex purchases and sales through networks of counterparts, in order to secure regular and timely flows and maximize returns given spreads between buying and selling prices at the times of deliveries. The first goal may be difficult to achieve under some circumstances, due to technical and logistic reasons and the latter may be even more problematic if the prices of refined products are lower than the ones of crude at the moments of deliveries for refining. In order to cover such potential losses, instruments have been designed, also used in other financial areas and already considered by us for the protection of investments. In the oil sector the most employed among hedging tools are futures, and their market has increasingly developed so that, besides the traders linked to oil-related companies, many specializing financial institutions have been established, both for the spot (short term transactions with direct payment at delivery) and particularly the future markets. It is worth reminding that the spot market refers both to the crude oil and its refined by-products. Market prices are continuous and round-the-clock and daily crude closes are the bases for pricing all derived products. The three major oil spot markets are London, where the European Brent type is traded (mainly coming from the North Sea), New York for the American oil (WTI-West Texas Intermediate being its reference product) and Singapore for the Dubai Light type. Other less relevant spot oil markets exist in production countries, mainly the Persian Gulf, and their main participants are oil companies. The spot markets for refined product are numerous. Among the main European ones we may just cite Rotterdam/Amsterdam and Genoa, where tradings from the Mediterranean area are carried on. Oil trading globalization has favoured relatively regular flows but has also affected pricing patterns and price volatility, particularly in the futures markets. (to be continued) - *GLT*

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(Part Four) Oil trading is carried on in the spot and future markets: the latter is important in economic terms, due to its hedging function during the phases of adverse price trends and financially, in representing an investment opportunity for private and institutional operators. We just remind how futures work through a plain example. Let us consider a purchase of 100,000 barrels of crude oil at USD 60 per barrel, for delivery to a refinery after 3 months, at the same price. This agreement is also a financial contract, unlinked to the physical transaction and traded apart from it. If, 3 months later, that is at the time of delivery, the price has come down from 60 to 50 USD, the trader loses money as he could now buy at 50 what actually bought at 60 USD. The trader suffers a "physical" loss, but balances it with a paper gain of the future contract. On the contrary, if the price at delivery is USD 70, the trader has a return on the crude oil and a paper loss on the contract, because the future subscriber will ask for the delivery at 60 USD, as agreed, for what he can now sell at 70.

Obviously such market needs a wide base of operators, also external to the oil sector, who are willing to take the financial risk those transactions involve, in view of substantial rewards linked to favourable price trends. The market, although risky and volatile, thus may offer rich returns through the use of several strategies and instruments which will be considered later on. However short selling operations are also possible when the expected price trend is negative. Crude oil and related future contracts are traded on different markets. We already mentioned the ones involved in the actual commodity, while the main oil futures' trading markets are the NYMEX (*New York Mercantile Exchange*) and the IPE (*International Petroleum Exchange*) in London. It is worth noting that due to the peculiarly financial nature of oil futures, just a small portions of contracts (hardly 5% of them) is closed with a physical delivery. Actually the most part of them is settled at expiration through the virtual repurchase of the underlying in the form of the prices' spreads. *(to be continued) - GLT*

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(Part Five) After considering how oil trading is carried on by the sector participants and the role of oil futures in hedging against price fluctuations, let us turn to crude oil as an opportunity for ordinary financial investors. Investing in energy, specifically in oil, may be pretty interesting today, for two main reasons at least: structural market conditions and the expected trends in supply and demand curves make that commodity appealing. Moreover, in a current financial phase which is marked by uncertainty and diffused negative sentiments towards the “paper finance”, turning back to real and tangible assets may be reasonable. The crude oil price's evolution supports such vision, due to the several features this unique commodity involves.

When looking at a long term price chart, as expressed in 2008 USD, so to make values comparable, we note a long period of stable, even slightly decreasing prices, under 20 USD per barrel, until the Autumn of 1973, when a very disrupting event took place, the Yom Kippur War and the Arab embargo that followed, causing the first steepest price increase, and also fuelling hard economic and financial crises in many Western countries together with the subsequent inflationary cycle. The price suddenly reached 40 USD, more than doubling in just few days, then holding those levels until the second dramatic series of events, the Iranian Revolution in 1979 and the Iran-Iraq War, taking the crude price up to over 70 USD. The price then tumbled towards 20-30 USD, until the Gulf War erupted in 1990-1991 and the series of cuts operated by the OPEC at the end of the 90's. The terror attacks on September 11, 2001 mark the most sudden and impressive phase of crude price's increase, with a high of 145 USD per barrel in July 2008, followed by another fall induced by the looming global recession, down to a low of 35-36 USD in January 2009. From there a steep remounting has started, up to the current levels just over 80 USD. Such historical evolutions may induce some remarks and be of help in assessing and selecting the most suitable instruments for investing in this unique commodity. *(to be continued) - GLT*

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(Part Six) Oil is currently present as an investment product in many portfolios, due to its favourable market conditions, according to what we noted in the first part of this series. There are many instruments available for investing in it. The major choice related to this special item is between investing in the physical commodity itself, that is in a direct form, or rather in oil-related companies, so following their stock market's trends. In such case the selection may include the big oil companies operating in production, refining and distribution, or oil service companies and energy-linked institutions of different types. The choice is large and many combinations are possible on both geographical and sector basis.

The most direct form of investment are the futures on Brent (London quote) or WTI (New York quote) crude oils, through which the investors gets a return in the form of spreads between current and delivery prices, or suffers losses in case of adverse price trends. However such future contracts involve huge underlying amounts, so that they require large sums of money and are normally within the reach of just very affluent or institutional operators. The most diffused and efficient way to invest in oil directly is via the ETF's or trackers. There are many of them from different issuers and promoters. They replicate the evolving prices of Brent and WTI crude quotes and the investor may place any amounts he or she likes in them. Trading is easy, timely and pretty cheap if compared with other instruments. However if one carefully checks the historical curves of such ETF's against the curves of the related oil spot prices, an overall high correlations appears, but also some sorts of negative differentials during certain market phases. That is particularly the case when volatility is high, due to economic, technical-logistic or geopolitical reasons. Indeed that is the result of the so called "contango effect", as explained in the next article. *(to be continued) - GLT*

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(Part Seven) The main instruments for directly investing in crude oil, that are not in oil and oil-related service companies, are ETF's, or trackers, which are particularly diffused due to their convenience in terms of fees, trading time and transparency. They tend to replicate the evolutions of Brent (London) and WTI (New York) oil quotes. Yet we have also noted that during some market phases the movements of these instruments may show a negative spread if compared with the crude prices themselves. Indeed there is a technical reason for such gaps, in that almost all ETF's are based not on spot prices but rather on future prices, being the oil's future market largely prevailing in terms of both numbers of transactions and their amounts.

If we then look at the series of the oil future prices for the different delivery times, we may compare it with the yield curves of currencies: the longer the expiration dates, the higher the prices (or the yields) are supposed to be, due to higher elements of uncertainty affecting them, the costs of financing, and so on. In the case of a non perishable commodity, as the crude oil is, stocking cost and other technical charges must be taken into account too, which normally increase along with time. That is the normal picture. However, for crude oil too (as well as for perishable items of course, e.g. agro-food stuffs), and even for money, market conditions may determine a "shortage" in the short term more than on a longer basis, so that the yield – or price .- curves become inverted, with higher prices for nearer deliveries and lower prices for longer ones. This distortion of the normal price curve may be caused, in the case of oil, by momentary technical and logistic reasons, geopolitical crisis which may affect current supplies... Such distorsive gaps tend to normally smooth and disappear on the long run. Some ETF's are becoming available, which are based on oil spot prices, so that such gaps are absent and the correlations become absolute. *(to be continued) - GLT*

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(Part Eight) As an alternative to ETF's, also called "trackers", in that they strictly replicate the price evolutions of crude oil, having its spot or future quotes as their underlyings, the investor may select a traditional mutual fund which is linked to the oil industry. They may have a portfolio including shares of just major oil companies, as well as oil related services and energy linked businesses. Otherwise, oil may be present within a basket of different natural resources and other basic commodities. Moreover there are funds just devoted to "traditional" energy and other ones which also consider "new energy" themes. So the range of investment opportunities in oil related funds is pretty wide. If we compare the historical evolution of crude oil's prices and the performances of most energy funds and baskets, we may note that during certain volatile phases, one or the others have alternatively come out as winners. However, on longer terms, let us say 5, 10 or more years, just few energy funds have been able to "beat" the physical oil itself, so that "direct" oil ETF's may be absolutely declared as the best instruments in the area. Moreover ETF's have other positive features if compared with a traditional fund, in that there is a time delay between the investor's decision and the fund's actual trading time, usually several days, and that takes to notable purchase or sale price uncertainties. On the contrary an ETF is traded immediately at a transparent current price like an ordinary share, and transaction fees are usually lower. That does not exclude that several energy funds with well selected portfolios and smart active strategies have achieved remarkable returns on both short and longer terms.

(end) - GLT

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