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Buffett Buys Exxon

The sage of Omaha has recently taken a $3.75 billion position in ExxonMobil. We view this move with great interest and are pleased to see some contrarian value investors getting involved in the energy sector.

Warren Buffett has made few significant investments in the energy sector in recent years. There was a $7 billion investment in ConocoPhillips mostly acquired in 2008, a $500 million stake in Suncor in mid-2013 and now a new $3.75 billion position in ExxonMobil.

Although he regarded his ConocoPhillips investment as a “terrible mistake”, we would argue that Buffet’s recent track record in energy has actually been pretty solid. An investment in ConocoPhillips made in May 2008 would have generated a total return of around 37% as of 11/30/13 and would have beaten the MSCI World index total return of 25% over the period. In early 2008, ConocoPhillips screened as a typical value and restructuring story within the energy sector and the subsequent spin-off of Phillips66 had created significant shareholder value. Despite the extremely volatile crude oil price and broader market movements in the 2008/2009 period, the investment in ConocoPhillips as a company was, in our opinion, pretty sensible, offering a reasonable return.

The investment in Suncor has been very successful so far. We estimate that it has delivered a positive return of just under 20%, as of 11/30/13, clearly a very good return in a six month period and one that we believe could continue to deliver as North America demands production from the oil sands in Canada. We are very happy holders of Suncor in the Guinness Atkinson Global Energy Fund.

So, what has Buffet actually bought? At a market cap of $420 billion, ExxonMobil is the biggest oil company in the world with 4.3 million barrels/day of production split just over 50% in oil and just under 50% in natural gas. We expect its top line production to grow around 1% annually, which when combined with a potential share buyback program, it could generate a per share production growth in excess of 5% annually over the next few years. While the dividend yield of 2.5%, as of 11/30/13, could be considered mediocre, the return to shareholders is supplemented by the continuous and meaningful share buyback program. ExxonMobil has been a highly profitable company and the stalwart of the global energy sector.

This stock doesn’t come especially cheaply at the moment. ExxonMobil is one of the more ‘expensive stocks within the global energy sector (trading at 12.6x price per earnings (P/E) and 9.3x Enterprise Value (EV)/ Debt Adjusted Cash Flow (DACF) for 2013), although cheap versus the S&P 500 (trading at 16.5x P/E for 2013). We still see an upside in ExxonMobil shares, based on long term Brent oil prices of around $100/barrel. On the basis of a $100/barrel oil price assumption, we believe an investment in ExxonMobil could potentially deliver a compound return up to 10% annually based on the combination of production growth, share buybacks and dividend payments over the next five years. Nice, but not outstanding, relative to the energy sector as a whole.

…and why has he bought it? Perhaps Berkshire Hathaway considers ExxonMobil like a utility company with oil price leverage. Berkshire Hathaway owns a number of utilities directly and Exxon could be aligned with that group by offering a consistent dividend yield but with the added attraction of exposure to higher world oil and gas prices. Additionally, Exxon has underperformed the broader US markets over the last five years, and Berkshire Hathaway seems to be flexing its contrarian muscle in this investment.

Despite the size and breadth of ExxonMobil's business, the oil price is still the major driver of ExxonMobil's share price. Since 2001 Exxon's share price has been correlated 82% with the 12 month forward Brent oil price. The correlation is higher than the correlation between ExxonMobil and the S&P 500 Index (47% r squared (R^2) and the Dow Jones (57% R^2). However, ExxonMobil is much less correlated to the energy sector than many of its US energy sector peers. While Warren Buffett has stated before that he has "no special insight into the future movements of oil price", we think that that Berkshire Hathaway would have to have a view that future oil prices will be higher than the current forward curve in order to justify this move. We would argue that Exxon Mobil shares start to look expensive versus their peers on the basis of a $90/barrel Brent oil price (the five year forward Brent oil price, as of 11/30/13).

To be fair, Berkshire Hathaway doesn't have many options available to it, if it wants to invest these kinds of sums in concentrated positions and still maintain some liquidity. Exxon shares trade around $1.25 billion per day, which is nearly double the volume of Chevron and around four times the volume of the North American domestic peers. To get this kind of concentrated exposure, there are few other names he could have considered.

These all seem to be reasonable enough reasons to buy ExxonMobil for Berkshire Hathaway: suitable liquidity, contrarian characteristics, free cash generation and, more than likely, a view on oil prices being in excess of the current forward curve.

So, what are the implications for the energy sector? We view the Berkshire Hathaway move with great interest. The energy sector has been a particularly poor performer for the last two and a half years, and we see the sector as offering a deep value contrarian investment opportunity based on oil prices of $100/barrel. We take some comfort in seeing contrarian value investors getting involved in the sector – and we very much hope that Buffet is right again this time!

We concur with the stock selection and hold a 3.4% position (as of 11/30/13) in ExxonMobil, as well as similar weights in all five of the Super Majors (ExxonMobil, ChevronTexaco, BP, RD/Shell and TOTAL). As a more 'nimble' investor in the energy sector, we invest in core value names like the Super Majors as well as global energy names with combinations of greater oil price leverage, growth and value characteristics than those apparent in ExxonMobil alone. Warren Buffett's buying ExxonMobil highlights our viewpoint that the outlook for the energy sector is attractive, and we think ExxonMobil is currently a sensible component of a balanced allocation to the sector.

Jonathan Waghorn, Portfolio Manager of the Guinness Atkinson Global Energy Fund.

For more information about the Guinness Atkinson Global Energy Fund, including recent performance and holdings, visit the fund web page.

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Past performance does not guarantee future results

Mutual fund investing involves risk and loss of principal is possible. The Fund invests in foreign securities which will involve greater volatility, political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning it concentrates its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund. The Fund also invests in smaller companies, which involve additional risks such as limited liquidity and greater volatility. The Fund's focus on the energy sector to the exclusion of other sectors exposes the Fund to greater market risk and potential monetary losses than if the Fund's assets were diversified among various sectors. The decline in the prices of energy (oil, gas, electricity) or alternative energy supplies would likely have a negative effect on the fund's holdings.

This information is authorized for use when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, charges and expenses related to an ongoing investment in the Fund. Please read the prospectus carefully before investing.

r-squared is a statistical measure that represents the percentage of a fund or security's movements that can be explained by movements in a benchmark index.

Dow Jones refers to the Dow Jones Industrial Average, which is an index that provides investors a picture of the equity market

S&P 500 Index is is a U.S. market index of 500 companies that gives investors an idea of the overall movement in the U.S. equity market.

MSCI World Index is a capitalization weighted index that monitors the performance of stocks from around the world.

Dividend Yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price, and minus taxes, is considered the return on investment.

P/E = Price/Earnings, a ratio used to define value to a stock

EV/DACF = Enterprise Value (EV), which is an indicator of how the market attributes value to a firm as a whole, divided by Debt Adjusted Cash Flow (DACF), which is a financial ratio commonly used in the analysis of oil companies, representing the after-tax operating cash flow, excluding financial expenses after taxes. DACF = cash flow from operations + financing costs (after tax) + exploration expenses (before tax) +/- working capital adjustment

Click here for a current list of holdings for the Guinness Atkinson Global Energy Fund.

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