Not Your Father's Utility Stocks

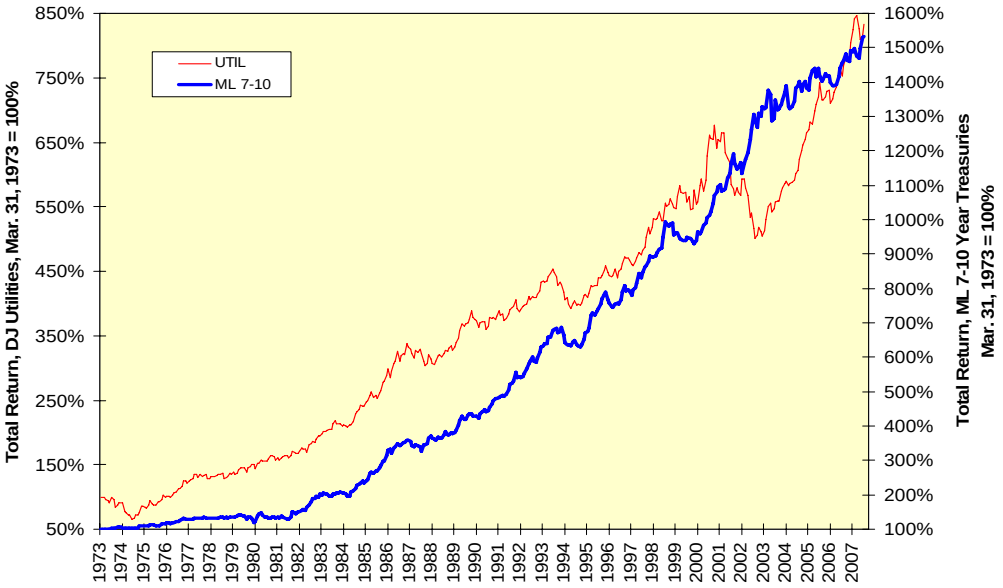
Do all cultures have an equivalent to Aesop's fable of the tortoise and the hare? Probably, and if they do not, they should, especially if the society involved has an investing community. While no one admits they are in this business to make a fast buck – no, that would be wrong! – let's be honest and say it has crossed all of our minds from time to time. No one admits this to their risk and compliance officers, however, and who describes their trading system with some variation of "get and hunch and bet a bunch?"

Yet this business is far more of a marathon than a sprint, even though the latter's adrenaline rush may be more exhilarating than the former's endorphin high if we may mix hormonal metaphors. The performance of the Dow Jones Utility index relative to its two better-known and higher-octane cousins, the Dow Jones Industrials and Transports, is a case in point.

Lost in the unquestionably good investing environment prevailing since the passage of the Jobs & Growth Tax Relief Reconciliation Act in mid-2003 is the incontrovertible fact this decade will, barring some outstanding performance in 2008 and 2009, be the worst for investors since the 1970s. If we turn the clock back to the giddy days of the technology boom and triple-digit returns for a number of mutual funds in 1999 and ask, "What have the Dow Jones indices returned since the start of Y2K?" the answer is the Utilities have done the best. Their average annual total return through September 2007 has been 11.7%, as opposed to 4.6% and 7.7% for the Industrials and Transports, respectively.

This strong outperformance may be more surprising to investment veterans who were trained to think of utility stocks as slow-growth, bond-like instruments purchased for the purposes of capital protection and current income as opposed to growth. But even that generalization is wrong. The connection between bonds and utility stocks broke a long time ago and not in the way you might think given this decade's performance. If we go back in Chart 1 to the start of comparable data in March 1973, the Dow Jones Utility has seen a total return of 833% calculated on a monthly basis. The Merrill Lynch index of 7-10 year Treasuries has seen a total return of 1534% over the same period.

Chart 1: Bonds Outperformed Utility Stocks



Not only has the extent of bonds' performance been noteworthy, but the path of relative performance tells a story as well. The 1970s, which were awful for stock investors, were even worse for bond investors. Over the March 1973- September 1981 period, the total return on 7-10 year Treasuries was 28%, or 2.89% per annum. This was over a period when consumer purchasing power declined at a 9.33% average annual rate. Oh, and tax rates were higher, too.

When did utilities begin their outperformance? That started – and please do not laugh – in the late 1990s and into 2000 when Enron was rewriting the rules of what it meant to be a utility in a deregulated world. Their "asset-light" model would transform the industry from a staid collection of generate-and-bill firms who spent most of their creative efforts at state utility commission rate hearings into a set of high-multiple trading and risk management firms.

OK, so that did not work all that well. Can't fault a firm for trying, can you? Utilities, most of whom were transforming themselves into Enron wannabes, crashed along with the broad market into March 2003. They have outperformed bonds ever since.

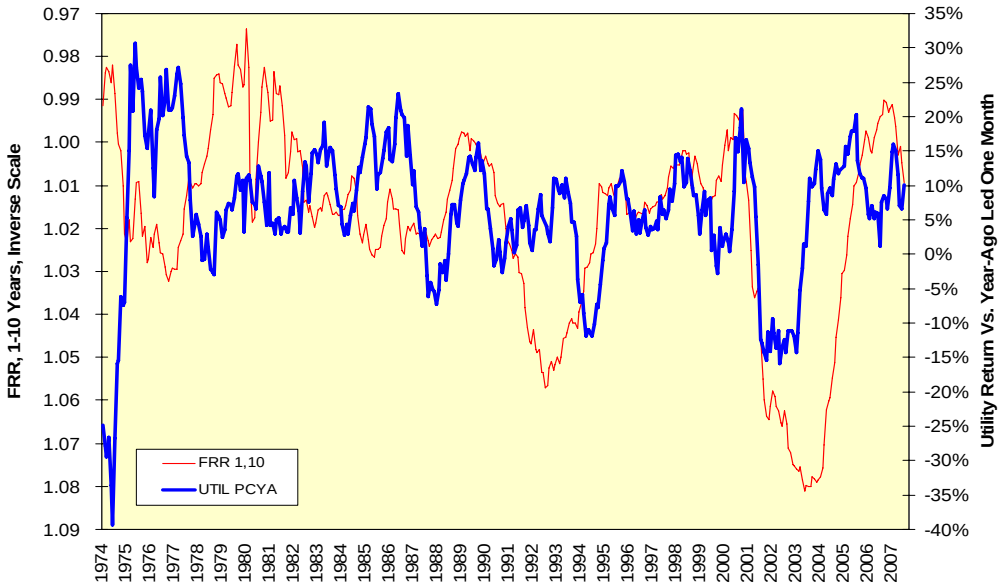
The Yield Curve

What can explain such an unexpected relationship? We have been taught three things about relative performance over long periods of time. The first is stocks outperform bonds. The second is value outperforms growth. The third is dividend-paying stocks outperform non-dividend payers. The comparison between 7-10 year Treasuries and utility stocks fails on all three counts, so we had better start asking why.

The yield curve is usually a good place to start. We can measure the shape of the yield curve by the forward rate ratio between one and ten years, the rate at which we can lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself. The more the FRR exceeds 1.00, the steeper the yield curve. The FRR, plotted inversely, can be compared to year-over-year total returns for utilities; we have discussed it in comparison to financial stocks in the past (see "Financial Stocks: Not Bending With The Yield Curve," May 2006).

Over the past three decades, the FRR has led changes in the year-over-year gains for utilities by one month on average. One conclusion noted in May 2006 is financial stocks do not all benefit from a steeper yield curve as some have alleged; only those firms in the borrow short / lend long world of banks, savings & loans and mortgage lenders really benefit from the steep yield curve. We see the same pattern in Chart 2 in regards to the utility stocks: Their highest year-over-year returns came during periods of flattening, not steepening, yield curves.

Chart 2: The Yield Curve And Utility Returns



Why would this be? Utility debt tends to be long-term; a utility borrows in both the bond and preferred stock markets for capital investment purposes, not to meet ongoing operating expenses. Their cash flow, however, tends to be short-dated, especially for their receivables. The steep yield curve does nothing to reduce their borrowing costs, but does reduce their short-term investment income.

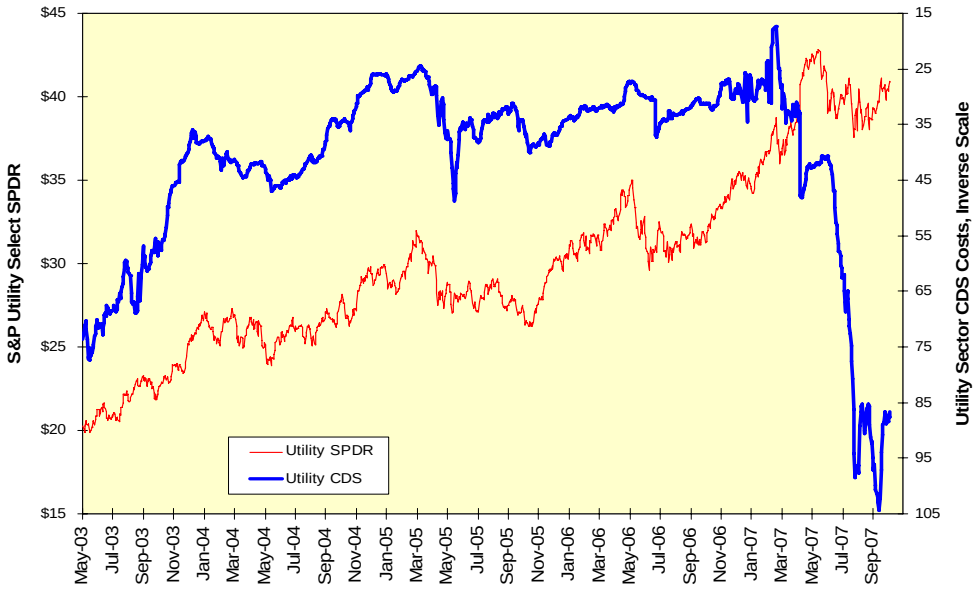
Credit Outlook

If utilities are large-scale borrowers, their credit rating is of the utmost importance. Let's return to a topic first discussed in December 2005 (see "Stocks Float On A Sea Of Bonds"), sector-specific credit default swap (CDS) costs. A CDS effectively is a put option on corporation's bonds. Two things make its costs, expressed in basis points, rise, deteriorating credit quality and any actions, such as a leveraged buyout, perceived to reward stockholders at the expense of bondholders.

Let's make a simple statement too often ignored in practice: If you do not want to own the corporation's bonds, you should avoid its stock as well unless there is a takeover afoot. Therefore, if we construct an index of five-year CDS costs across the S&P 500 utility index and compare it to the S&P 500 Utility Select SPDR, we should see an inverse relationship in Chart 3, and we do.

We can surmise, therefore, much of the strong outperformance of bonds by utility stocks seen since mid-2003 has been nothing more than a credit rally.

Chart 3: Utility CDS Costs And SPDR Price



Energy Costs

Finally, let's revisit an analytic tool introduced in October 2005 designed to measure the impact of primal market factors on the relative performance of stock industry groups (see "Tracking Market Factors' Impact On Stocks").

We might have every reason to believe higher energy prices as represented by crude oil and natural gas would have a negative impact on utilities. As an important aside, coal is the largest source of electricity, and most coal is sold on a long-term fixed-price basis. Uranium, the primary source of nuclear power, does not trade freely, for which we should all be grateful.

Standard & Poor's divides its utility sector, the one represented by the Select SPDR, into electric, gas and multiline utilities. If we calculate the relative performance of these groups to the S&P 500 as a function of crude oil and report only the statistically significant results, we find the betas against crude oil for electric, multiline and gas utilities are .0225, .0379 and .0669, respectively. For natural gas, the beta for gas utilities is .0171.

If we step back up from the industry group to the sector level and map the relative total returns of the S&P 500 utility index to the S&P 500 as functions of crude oil and natural gas prices in Charts 4 and 5, respectively, we see no negative impact of these two commodities' price surges on relative utility performance.

Chart 4: Utility Performance Not Hurt By Rising Crude Oil

Chart 5: Utility Performance And Natural Gas

Piecing The Puzzle Together

How can we tie all this together? If we accept we have been in a strong economy where utility capacity remained a scarce resource, utilities have been able to pass on their rising fuel costs to their customers. Scarcity explains relative performance on a stock market basis as well: When the value of existing plant and equipment is not threatened by a surge of new plant and equipment its value increases.

Restated, utilities have turned into cyclical stocks after generations (no pun intended) of being regarded as defensive stocks. This is consistent with their ability to weather flat and inverted yield curves and to prosper in the face of higher fuel prices.

Finally, utilities used to be regarded as an early warning mechanism for interest rates. Declining prices were viewed as a sign rates were about to rise, and vice-versa. If we accept utilities' new role as cyclical stocks, any future decline in price should be viewed as a warning of a recession. These are not your father's utility stocks.