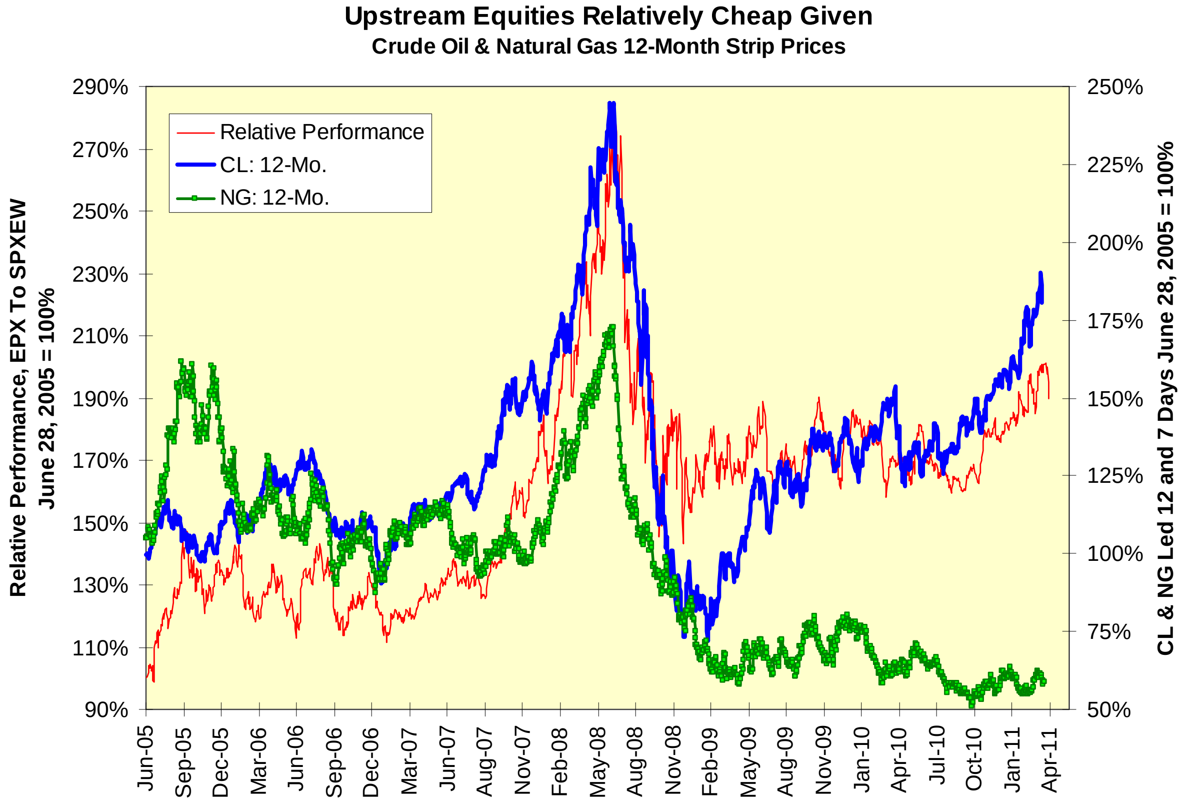
# Upstream With An Energy Paddle

If after discussions of the relative performance of silver and base metals miners earlier in the week got you thinking this whole commodity-linked equity thing is a breeze, let's turn our attention to a group related to two different commodities, crude oil and natural gas, whose linkages are far weaker than anyone besides me cares to admit.

Let's take a look at the SIG Oil Exploration & Production index, an equal-weighted index of 22 "upstream" or exploration & production firms involved with the oil and gas extraction business. This index can be compared to the S&P 500 equal-weighted index for a relative performance measure. As an aside, or perhaps more than an aside, I do not like these equal-weighted schemes. Yes, I understand capitalization-weighted indices such as the S&P 500 itself force you into ever-greater ownership of ever-pricier mega-cap stocks, but the equal-weighted indices reward smaller firms and their option-compensated managers out of proportion to their overall importance. Equal-weighting became popular after the dotcom-implosion and the over-exposure to the mega-cap stocks of the day, such as Microsoft, Cisco Systems, Intel and Oracle.

As equity markets look ahead, we should use twelve-month strip prices instead of front-month futures prices to eliminate seasonal effects and the pronounced distortions of the forward curves we have seen in recent years. What we see in the chart below should not surprise anyone. The crude oil strip price has left its natural gas counterpart in the dust and has outpaced the relative performance of the upstream stocks. The results would be even more distorted if we used total returns for the Dow Jones-UBS crude oil and natural gas indices as proxies for the commodity prices; the buy-and-hold strategy for natural gas is best left to masochists with psychological disorders. Not even a well-adjusted masochist would get near a long-only natural gas product such as the U.S. Natural Gas Fund.




**A Call Option In Waiting**

Where does this leave us with the embedded-option analog? Here we switch from an embedded short call option on the underlying commodities to an embedded long call option on natural gas. Right now the relative performance of the upstream stocks has been weighed down by low natural gas prices, but both their absolute return the long-term outlook for crude oil prices remain positive. This suggests if and when natural gas prices move higher the relative performance of the upstream stocks will get a strong boost. The cost of that boost has been defined as the cost of underperformance and can be observed above. This cost is offset by the potential for much higher relative performance in the future should the outlook for natural gas brighten.

Firms in this index especially levered to natural gas prices include Chesapeake Energy, Range Resources and Devon Energy.