

Water, The Other Liquid Market

Is there anything more annoying than perpetual scolds being right? They do not have to say, “I told you, so;” it is implied by their beatific smirks.

However, if I look backward across the landscape of the past forty-five years, I can see a number of places where the sky-is-falling crowd was right. These include energy consumption, which I first recall reading about in the mid-1960s; carbon dioxide, which I can recall reading about in Foreign Affairs in 1974; the impending fiscal tsunami of unfunded government entitlement liabilities such as Social Security and Medicare, also the mid-1960s.

Today’s subject, water and its relationship to energy production, also extends back to the early 1970s.

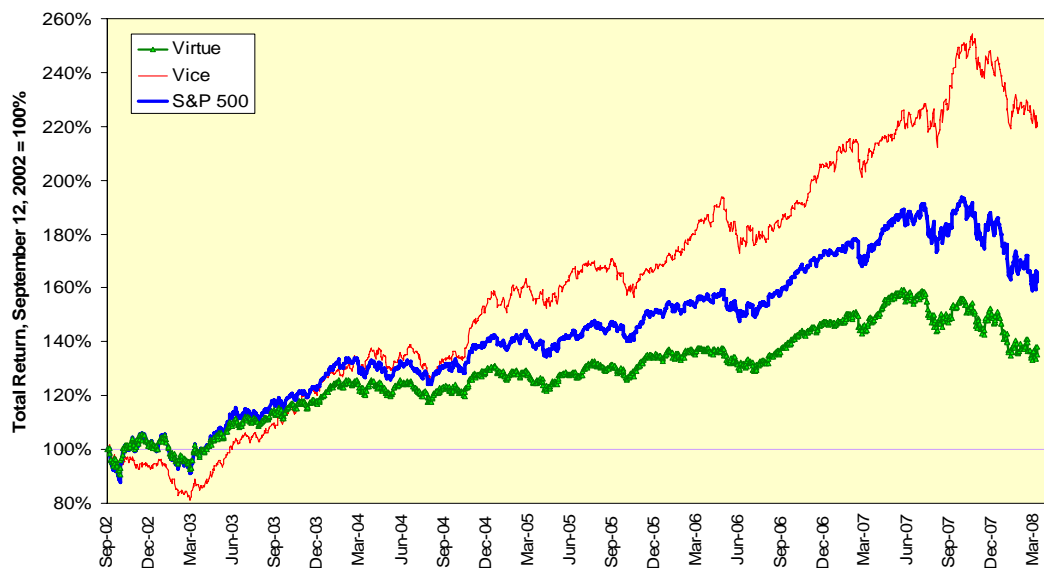
The only solace I can take is the scolds’ timing is and has been bad. If you are decades early in warning about a problem, no one is going to take you and your jeremiads very seriously after awhile. It has happened in recent market debacles such as the tech bubble and bust and everything we have seen in the past year related to the unwinding of the credit bubble, too.

Doing Well And Doing Good

Before we launch into water, let’s mock the world’s do-gooders out of force of habit. We can compare the total return of the Mutuals.com Vice fund, which goes out of its way to invest in tobacco, alcohol, gambling and military-related issues to the Domini Social Equity fund, which invests in “socially responsible” firms, whatever those are.

The relative performance of the funds against each other and the S&P 500 total return index is no contest. As money is not everything, may I suggest buying the Vice fund, shorting the Social Equity fund and donating the net profits to a charity of your choice? A win-win-win proposition it would be.

Vice Beats Virtue For Investors



Cleanliness Is Next To Godliness

Whenever a topic becomes hot, count on financial marketers to create investable indices, funds, ETFs and all other manner of products to separate you from your money in service to a higher cause. Standard & Poor’s has taken time out of its busy schedule of slapping AAA ratings on all manner of feculent ooze to create both a Clean Energy index and a Global Eco index.

The composition of the two indices is displayed below, with overlaps in boldface. As many of the holdings are domiciled outside of the U.S. and in currencies other than the dollar, we will rely on S&P’s calculation of their total returns in dollar terms.

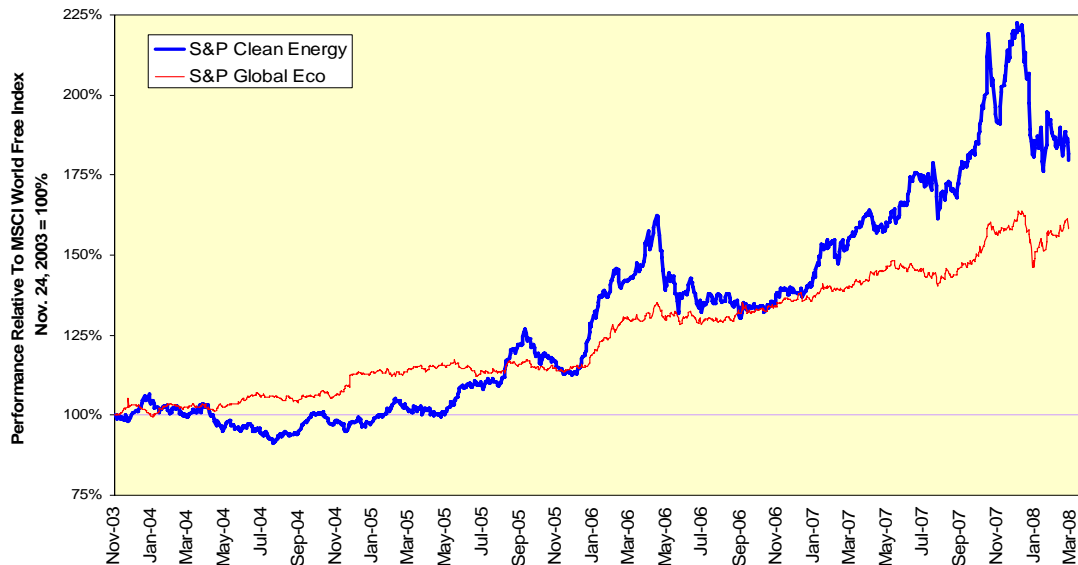
The S&P Clean Energy Index

The S&P Global Eco Index

Acciona SA	Aguas de Barcelona SA (Sociedad general de)
Archer-Daniels-Midland	Allied Waste Industries
Babcock & Brown Wind Partners Group	Archer-Daniels-Midland
Cemig-PN (Companhia Energetica de Minas Gerais SA) (ADR)	China Grand Forestry Resources
Conergy AG	Copel -PNB (Companhia Paranaense de Energia SA) (ADR)
Copel -PNB (Companhia Paranaense de Energia SA) (ADR)	Covanta Holding Corp
Cosan Ltd	EDF Energies Nouvelles SA
Covanta Holding Corp	First Solar Inc
EDF Energies Nouvelles SA	Gamesa Corp Tecnologica SA
Energy Conversion Devices	Geberit AG
Ersol Solar Energy AG	Iberdrola S.A.
Evergreen Solar Inc	Itron, Inc.
First Solar Inc	Kurita Water Industries Ltd
Fuelcell Energy Inc	Nalco Holdings Inc
Gamesa Corp Tecnologica SA	Ormat Technologies Inc
Iberdrola S.A.	Pentair Inc.
JA Solar Holdings Co Ltd	Plum Creek Timber Co.
LDK Solar Co. Ltd	Q-Cells AG
MEMC Electronic Materials	Rayonier Inc.
Ormat Technologies Inc	Renewable Energy Corporation AS
Q-Cells AG	Republic Services
Renewable Energy Corporation AS	Severn Trent
Solarworld AG	Sino-Forest Corporation
Sunpower Corp.	Suez SA
Suntech Power Holdings	United Utilities Plc
Theolia	Veolia Environnement
Trina Solar Ltd.	Vestas Wind Systems A/S
VeraSun Energy Corp	Waste Connections
Vestas Wind Systems A/S	Waste Management Inc.
Yingli Green Energy Holdings- ADR	Weyerhaeuser Corp.

The relative performance of these two indices against a global benchmark, the Morgan Stanley Capital International World Free index, is a testament to the willingness of investors to fund wind, solar and biofuel technologies. The relative performance of the Clean Energy index is a hare; that of the Global Eco index a tortoise.

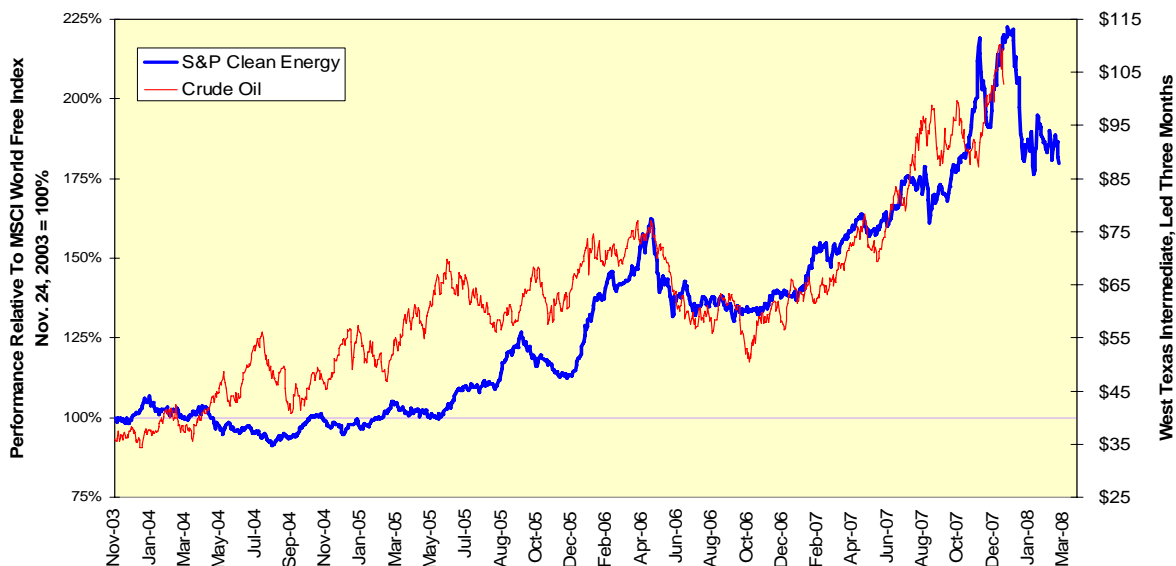
Clean Energy A Strong Relative Performer



The Crude Oil Connection

What drives the Clean Energy index? Why, dirty energy of course. If we map the relative performance of the Clean Energy index against crude oil, we find the stocks lead the commodity by three months on average. If this pattern holds, we should expect last week's weakness in crude oil to continue for another two months.

Crude Oil Drives Clean Energy Investing



The reason for this relationship is simple and brutal: Suppliers of alternative energy resources will capture the rent of higher crude oil prices. As crude oil sailed to and through \$110 per barrel, any manner of alternative energy scheme looked profitable. However, as the suppliers capture the rent, the marginal BTU of conventional energy will remain cheaper than the marginal BTU of alternative energy; for this to be otherwise, the laws of thermodynamic would have to become inoperative at your convenience, and this is unlikely to happen in any of our lifetimes.

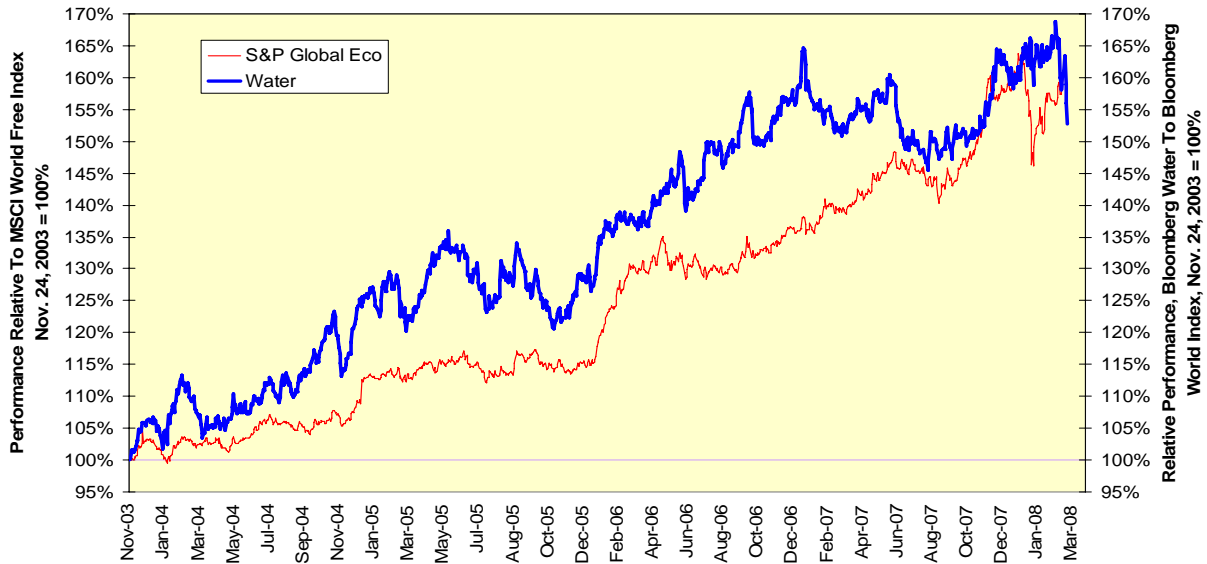
If crude oil prices continue lower – and I still think we are in a long-term bull market – alternative energy sources would become uneconomic rather quickly. All those oil shale boondoggles of the 1970s closed very quickly once crude oil prices fell in the 1980s.

Water Utilities

If the hare is propelled by crude oil, what propels the tortoise? Water or at least water utilities: The relative performance of the Global Eco index is matched very closely by one class of its constituents, water utilities. This is a simple theme; the multifactor Global Eco index is not.

If we map the relative performance of the Bloomberg Water index to the Bloomberg Global index against the relative performance of the Global Eco index, we see they are essentially the same trade.

Water As A Liquid Market



The water index is quite international; more than half of its weight is in France's Veolia Environment and the U.K.'s United Utilities. Other members include the U.K.'s Severn Trent, Spain's Sociedad General de Aguas de Barcelona, Brazil's Cia de Saneamento Basico, China's Shanghai Municipal Raw Water, Germany's Gelsenwasser and the U.S.' Aqua America.

As we move forward, we will find the infrastructure for agriculture, energy production and urban growth all will depend on moving huge quantities of the high-bulk, low-priced water. Like natural gas once, the value in water is in the transportation and delivery, not in the commodity itself. But is there a more basic irreplaceable resource or a better "Warren Buffett" commodity, one with a steady market and repeat customers, than water?

All of those energy projects, from shale to oil sands to ethanol to coal liquefaction, depend on water. Increasing food supplies depend on water. The increasingly parched U.S. Southwest depends on water. Forget social investing without a purpose. Here's a case where you can do both the world and your portfolio some good at the same time.