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STRATEGIES FOR SUCCESSFUL INVESTING

STRATEGY

While you look ahead toward a more attractive entry point into oil and gas stocks, this is the time to...

GO EASY ON ENERGY

Keith Richards

THE ISSUE FACING MOST INVESTORS when watching any strong market is to decide if it has run its course, or if it still has some legs left for further upside.

That said, energy stocks have benefited from the rapid rise in crude oil prices since August 2010. Will energy continue its strong run, or should you take your money and run?

When I make decisions for our managed portfolio clients at ValueTrend Wealth Management, I take a systematic approach with an emphasis on technical analysis.

I'd like to present you with the fundamental and technical reasons behind my decision to hold an underweight position in the energy sector at this time.

I'd also like to present you with an idea of how you might be able to identify the time at which energy stocks in general and oil in particular might reach a more attractive entry point.

We can use price-to-earnings (p/e) ratios on the TSX as one way to look at how cheap, or expensive, the market is.

The key to understanding p/e ratios when evaluating a security or market is that they are a relative indicator. The higher the p/e, the more expensive a market is – but only on a relative basis.

For example, at the time of writing, consensus forward earnings are currently valuing the overall TSX at a p/e ratio at about 15. The TSX S&P Energy sector has a current forward p/e ratio of over 19. Thus, energy is more expensive relative to the broader S&P TSX 300 index.

We can also compare the current p/e of the energy sector to its p/e at an earlier date. The S&P TSX energy sector had a p/e of 15.4 back in August 2010. Therefore, energy stocks are more expensive compared to their valuations a number of months ago.

The TSX utilities sector – which can be somewhat related to energy stocks because of the number of pipelines in the index – is also currently trading at a forward p/e of about 19.0, versus 16.3 back in August 2010. Both of these sectors appear to be overvalued at this time.

THE STATE OF OIL

Technically, oil is near the top of a 12-month channel (see the chart on the page five) with the linear regression channel drawn for oil from June 2009 to the present).

Linear Regression Channels help to identify trends, and the use of standard deviation (upper and lower bands) gives traders suggestions as to when prices are becoming overbought or oversold relative to the trend

It remains to be seen if oil will

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Oil near the top of its trading band

break and then hold above the top of this channel.

The recent big movements on oil coincide with energy stocks being at the top of their valuation range as I've mentioned (i.e. the energy sector PE of over 19 vs. the overall TSX PE of less than 15).

Seasonally, energy stocks will often decline in the New Year and trough in February. I am watching the energy sector to see if it will stage a pullback in the coming months to a more attractive buy point.

The chart pattern on oil suggests that the trading range bottoms in the low-$70's per barrel and peaks in the high $80's. So let's call it a $70 to $90 trading range to keep things simple.

Given the following facts, I believe that the energy sector presents more potential for risk than reward at this time. For this reason, I have underweighted the sector in our ValueTrend managed equity platform.

☛ We are at the top of oil's trading range at the time of writing.

☛ Energy stocks are expensive relative to the TSX right now.

☛ We are now into the seasonally weak months for oil.

If the energy sector defies the odds and stays strong over the early winter months, we will still have some exposure to these stocks in our managed portfolio through the broad S&P TSX 60 index.

We hold exchange traded funds (ETFs) such as **Horizon's S&P TSX 60 Shares** (TSX-HXT, $10.92) or **iShares S&P TSX 60** ETF (TSX-XIU, $19.29) for this need.

If oil prices settle back into the mid $70 to low $80's a barrel over the winter, I will be an aggressive buyer and expect to overweight the sector at that time.

If you want to play oil directly, consider the **Horizons Winter Term NYMEX Crude Oil ETF** (TSX-HUC, $11.28).

This ETF is hedged to Canadian dollars, and is based on a long contract (December 2011) to limit the negative effects of contango (where the price of oil declines to the spot price before the delivery date) to traders.

NATURAL GAS

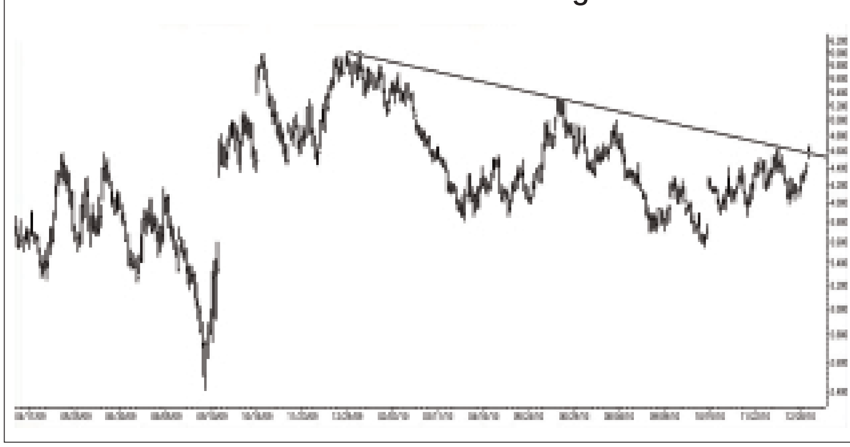
On the subject of energy, many investors seem to be talking about natural gas right now as a potential turnaround play.

As a technical analyst, I always come back to the question that my original teacher Ralph Acampora posed to the class. When viewing a stock, Ralph told us, you should ask: "What is it doing?"

All we really know is what a security is doing at this time, and what it has been doing lately. We don't know where the bottom or top is. Natural gas has been trading in a longer downward trend from its peak price of $14 per million British thermal units (MMBtu) in 2008.The shorter termed trend is also down.

Below is a chart of Natural Gas illustrating a short-term trend that has been in place since

Natural Gas trend still negative



February 2010.

If Natural Gas were to break the near term trendline to the upside and pop above $4.50 – look for a probable return to $6.00. If not, I would expect the downtrend to continue until support comes in at $3.50 or below.

Seasonally, natural gas does have a tendency to be an underperformer until the end of February, similar to the seasonal pattern for oil. I for one will not be adding Natural Gas to my managed accounts until I see a clean bounce off of about $3.50.

Should natural gas begin to look technically attractive, you can play the commodity using the **Horizons Winter Term NYMEX Natural Gas ETF** (TSX-HUN, $5.21), which is a long contract similar to its Crude oil ETF.

Or, you might look at the Claymore **Natural Gas Commodity ETF** (TSX-GAS, $2.75). This fund uses shorter termed contracts in their portfolio.

To play the equities for both oil and natural gas, consider the **BMO S&P TSX Equal Weight Oil & Gas ETF** (TSX-ZEO, $15.98) or the **iShares S&P TSX Capped Energy Index ETF** (TSX-XEG, $20.24).

From my perspective, now is likely not the ideal time to initiate new positions in the energy sector. However, a pullback into the price zones mentioned above may occur later this winter.

In that case, I will be taking a very hard look at this sector. You can follow my thoughts on the technical timing for the energy sector and other financial assets on my weekly blog at *www.smartbounce.ca*. ▼

Keith Richards may hold positions in the securities mentioned in this article. The opinions expressed are those solely of Keith Richards and may not necessarily reflect that of Worldsource Securities, its employees or affiliates. The contents are for information purposes only and do not represent investment advice.