



# Opinion: Investors are looking at the wrong oil prices

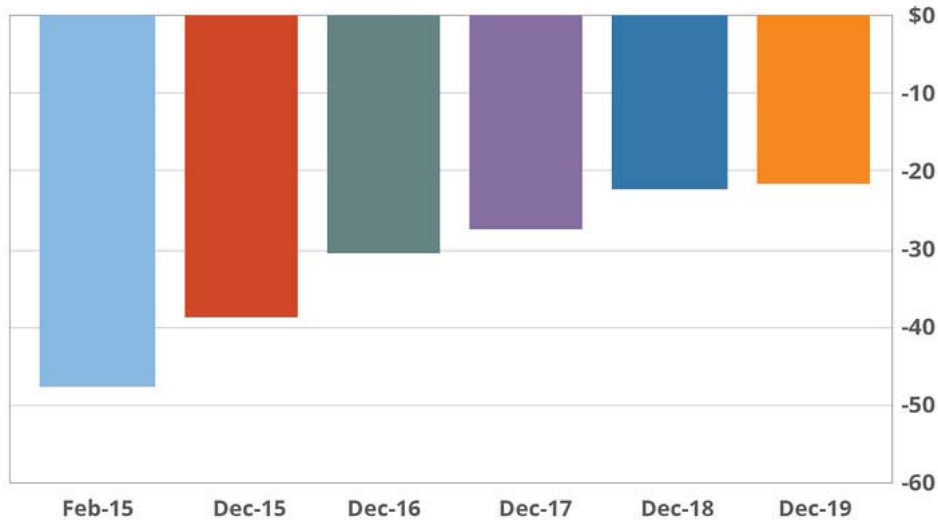
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There's a big discrepancy between spot and futures prices

## Oil futures telling a far different story

Price drop since 9/30/14 of Brent crude futures contracts of varying lengths



Source: Hulbert Financial Digest

CHAPEL HILL, N.C. (MarketWatch) — Crude-oil futures are telling a far different story than the spot price is.

Yet, curiously, it's the spot price that gets all the headlines. While oil has been plunging, futures contracts expiring a couple of years from now have fallen by less than half as much. The Brent futures contract for December 2016 delivery, for example, currently trades for more than \$65 per barrel. A contract with a December 2018 delivery goes for around \$72 a barrel.

The investment implication of those prices is far different than for the current \$47 spot price, according to Campbell Harvey, a finance professor at Duke University who brought this situation to my attention. In an interview, he argued that investors should be focusing on the price of the longer-term futures when making their investment decisions, since that is the market's best guess of where oil is going over the longer term.

As an example, Harvey referred to shale-oil projects whose cost of production is much higher than the current spot price, a fact that has led some short-sighted investors to conclude that those projects will never be profitable. That conclusion rests on faulty logic, however, since many of those projects are profitable at the higher prices available in the futures market.

Harvey believes that, by focusing exclusively on the lower spot price, investors may be overreacting. They may be unfairly

punishing industries, like oil exploration, whose profit is dependent on a high price of oil, and unfairly boosting the prices of companies in industries for which oil represents a major cost of production.

An example of this latter industry would be airlines. No doubt many investors are extrapolating into the indefinite future how profitable the airlines will be if oil were always priced in the mid-\$40s. Assuming the futures market is right, those investors will be very disappointed.

One way to exploit investors' possible short-sightedness is to invest in industries that are being unfairly punished (such as oil producers) while shunning those that are unfairly benefitting (such as airlines). An aggressive way of exploiting investors' potential overreaction would be to create a hedge that is long the oil producers and short the airlines.

Such a hedge has the advantage of being market neutral. It instead should turn a profit so long as the oil producers outperform the airlines, including, for example, falling by less than the airlines in the event of a broad-market decline.

You have several exchange traded funds to choose from when increasing your exposure to the oil-producing industry, such as the SPDR S&P Oil & Gas Exploration & Production ETF [XOP](#), +4.54%. While ETFs benchmarked to the airline industry are hard to find, there are ETFs that give you heavy exposure to both airlines and other transportation companies for which energy also is a huge cost of production.

Examples include the iShares Transportation ETF [IYT](#), +1.15% and the SPDR S&P Transportation ETF [XTN](#), +1.04%

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