



Under the Hood: What's in *Your* Index?

(An Ongoing Series – July 2016)

Part 1: The Exxon Paradox: Review of Exxon's recent Stock Price and Earnings

Few would argue that the earnings of the oil production industry are not under immense pressure at the moment. As of June 8, 2016, the price of oil has declined by roughly 60% from the prior peak of \$120 per barrel in April 2011. The past year has seen a not insignificant number of bankruptcies.

ExxonMobil Corp. has been no exception to that pressure. The company generated peak earnings of \$9.70 per share in 2012. In 2015, reported earnings were only \$3.85, a decrease of 60% (not coincidentally, matching the movement of overall oil prices).

ExxonMobil Corp. (XOM)

Year	Revenues (Millions)	Net Income (Millions)	EPS	Y/Y Change	Year End Share Price
June 8, 2016					\$90.78
2015	\$259,488	\$16,150	\$3.85	-49.3%	\$77.95
2014	394,105	32,520	\$7.60	3.1%	\$92.83
2013	420,836	32,580	\$7.37	-24.0%	\$89.53
2012	451,509	44,880	\$9.70	15.2%	\$88.96
2011	467,029	41,060	\$8.42		\$84.76

Source: Company Reports

Yet, here is the most remarkable figure. On the first day of 2012 the ExxonMobil shares closed the day at \$85.12 – this was the environment of \$100-\$120/barrel oil, and the most robust earnings period for oil companies in decades. Would anyone care to guess ExxonMobil's share price as of June 8, 2016 - \$90.78. That's right, despite a 60% decline in earnings, ExxonMobil actually traded at a higher share price, by 7.1%, than in the beginning of 2012. It's as if investors believe ExxonMobil is not even an oil company, or at a minimum that the company's earnings are immune to variations in oil prices, which clearly they are not.

As viewed in this table, the company's share price demonstrated almost no volatility over that last five years – despite a massive decline in the price of oil, which in and of itself is an extremely volatility commodity. There is, however, one explanation. ExxonMobil is contained in a nearly infinite variety of ETF strategies: energy, dividend-paying, value, large cap, quality dividend, low beta, S&P 500 ex-healthcare, defensive, covered call, to name but a few. It is even a 2.04% weight in the Global X S&P 500 Catholic Values ETF. This link provides all the ETFs with exposure to Exxon Mobil: <http://etfdb.com/stock/XOM/>

It is no surprise that the largest shareholders are the ETF managers (Vanguard is the company's single largest



shareholder, at 6.4%, followed by State Street at 4.5%). This has a consequence. The ETFs, and therefore, the asset allocators, buy its shares for reasons beyond the direction of oil prices or of the company's earnings. It is required as raw material for the industrial-scale investing that they practice. It has scarcity value in that there are a limited number of companies of sufficient size and share trading liquidity that can meet their needs. This lack of reliance on fundamental analysis is not unique to just the ETFs that own ExxonMobil – it has actually become the cornerstone of the entire ETF industry.

Nevertheless, consider the following example. Imagine that an investor had correctly predicted oil would decline from \$120/barrel in 2011/2012 to below \$50/barrel, as is the present price – roughly a 60% short sale profit on the price of WTI. However, if this investor had the great misfortune of using the largest oil producer in the world as the short-sale vehicle, reasonably presuming that its operating leverage might result in yet greater declines, this unlucky investor, correct as the fundamental analysis may have been, would have actually experienced a loss on this trade. Surely, there has to be a better way.

Part 2: Exxon Mobil Corp. Stock Has Been Unsuccessful at Tracking the Oil Rebound

Since reaching a low of \$27/barrel in mid-January of this year, the price of oil has risen by about 75% to the current \$49/barrel level. This was substantial and swift, occurring over the course of only five months.

This is actually even more important within the context of broader asset allocation, the largest component of which is equities. The S&P 500 Index is only up 3% this year – some investors, therefore, have sought exposure to oil in order to generate additional returns. Of course, the most convenient vehicles are shares of the largest and most liquid exploration companies, such as ExxonMobil, which also can be accessed through the largest energy-related ETFs.

One way to measure this is to simply look at the net flows of certain ETFs. The following examples use the March 1st-May 30th 2016 date range, as the upward movement in oil prices began in earnest in March. According to ETF.com, the iShares U.S. Energy ETF (IYE) received \$153 million of net inflows during this time. This stands to reason, as ExxonMobil is 26% of this fund. Similarly, the Energy Select Sector SPDR Fund (XLE), in which ExxonMobil is a 19% position, has had \$232 million of net inflow. These funds, which cannot be said to be diversified, have been used by investors to gain exposure to oil.

However, was this the most effective security to capture such returns? Both IYE and XLE returned a nearly identical 32% since oil prices reached a low on January 20, 2016. Recall that the increase in the underlying commodity was 75%, or more than double the ETFs' returns.

Part of the reason for this relative underperformance was, naturally, ExxonMobil. Here is an interesting exercise. In 2012, the most recent peak in oil prices, the company earned \$9.70 per share – for context, ExxonMobil is forecasted to earn only \$2.65/share this year. If a basic 12.5x price/earnings multiple (appropriate for a deeply cyclical company and, in fact, nearly identical to the actual ExxonMobil trailing 10-yr P/E of 12.6x) were placed on prior high earnings, the share price would be \$121 – a 35% return relative to the current price of \$92. However, ExxonMobil required \$100-\$120/barrel oil to generate close to \$10/share of earnings. If oil returns to \$120 per barrel, 3x the current price, this would imply a ~150% increase from current levels. Most investors are not aware that ExxonMobil is no longer a proxy for oil prices.

It, therefore, can be clearly argued that if the investor believes oil prices will rise substantially, one would suffer



massive relative underperformance by owning ExxonMobil, or for that matter, the large energy ETFs, many of which allocate more than 15% of the index to this single company.

Part 3: The Great Index Transformation: From tools for diversification, to pools of idiosyncratic risk.

The problem with models in the current environment is that each model ultimately is an attempt to replicate a rational, sober valuation process conducted by a human being. The investment process, though, is being practiced by a machine. For instance, in the case of the energy sector, the largest index by far is the \$14 billion SPDR Energy Select ETF (XLE). Approximately 19% of XLE is invested in Exxon.

If a rational, sober investor chose to invest in the second-largest energy ETF, it would be the Vanguard Energy ETF (VDE). This fund has about \$3.7 billion in assets under management. Of course, as might be anticipated, its largest holding is Exxon, which represents 20.5% of assets under management.

The third-largest energy ETF is the S&P SPDR Oil and Gas Exploration and Production ETF (XOP). This fund has only \$2.1 billion of assets under management. For the past five years, XOP has vastly underperformed XLE. The latter yields 3.84%, whereas XOP yields 2.24%. XLE is also far less volatile than XOP.

The only way that one might favor XOP over XLE would be if the individual companies in the index represented better value. In order to do this, however, one would need to analyze the individual companies and make a valuation determination. If one did this, in practice, one would be engaging in active management, which is contrary to the basic premise of all indexation: that active management is futile, since all that is knowable about company fundamental attributes is already factored into prices.

Nonetheless, even if one rejected the basic premise of indexation and practiced active management, with the index viewed simply as a package of equities, one would not entirely divest oneself of Exxon. The biggest position in XOP is SM Energy (SM), at a current 3.06% weight. The fund also has Exxon at a 1.95% weight.

It would seem self-evident, without any conscious design apart from a bias towards liquidity, that the indexation industry always will channel significant amounts of money to Exxon, irrespective of valuation parameters. This factor, which is nothing other than the operation of supply and demand, is a much more plausible cause of the current valuation of Exxon. In other words, the valuation parameters of Exxon do not induce demand for Exxon shares. On the contrary, the mechanically induced demand for Exxon shares is the cause of the current valuation. And, of course, one may extend this understanding to large-capitalization companies in other industry sectors that have come to serve more as liquidity vehicles for ETFs than as investment instruments.



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