Energy Exchange Traded Funds

- Energy exchange traded funds have exploded in recent years.
- In principle, this is a positive development because it has made investing in the energy sector less expensive, thereby providing more funds for capital spending in the sector.
- Most recently, investors are voting with their purse: year-to-date returns on “alt energy” bets are in the plus column.

Exchange traded funds (ETFs) are financial securities that track an index of equities. There are also ETFs for commodities, like oil, and also for bonds, but the largest number of ETFs are comprised of equities. While ETFs have been in existence for many years, it is only in the last decade that they have grown significantly. The transaction costs of ETFs are lower than for mutual funds; unlike mutual funds, they trade continuously throughout the day as investors buy and sell them.

There are dozens of oil commodity ETFs and over 42 energy sector equity ETFs with assets of nearly $40 billion as of mid-August. Energy sector ETFs include investments in large oil integrated companies such as Exxon Mobil and Chevron, but also oil refiners and servicers such as Valero and Halliburton. Overall, these energy sector ETFs represent a small fraction of the total value of all U.S. equity ETFs with funds under management estimated to have exceeded $1.3 trillion last year (see top chart).

Recently, both oil and energy sector ETFs have fared poorly. As of mid-August, year-to-date (YTD) returns have been broadly negative. The second chart shows a selection of the top oil and energy sector ETF returns with their ticker symbols.

In stark contrast, there are many “alternative” energy sector ETFs — which hold assets tied to solar and wind such as Vestas and First Solar, as well as companies tied to batteries and electrified vehicles such as Tesla — which have done very well recently. The third chart shows the top ETFs in this category and their YTD returns as of mid-August. Guggenheim Solar ETF (Ticker TAN), up 30% so far this year. To be sure, many of these ETFs are still below peaks seen in 2014, but they have grown in value over the last 12 months in contrast to the conventional energy ETFs.

Admittedly, the ETF funds under management in this category are much smaller than for the conventional energy-related ETFs, but the solid returns are noteworthy, especially the double-digit 5-year returns (not shown). Underlying fundamentals support this growth. The bottom chart from the American Wind Energy Association shows U.S. installed wind capacity through 2016. Cumulatively, capacity now stands at over 82 GW, double the amount installed as of 2010. Bottom line: investors are being rewarded for alt energy holdings.