Downstream investment pricing guidelines

Last week, I discussed my admiration for the work of my former colleague Richard Bernstein and began giving my own interpretations and comments for the 10 Guidelines Studied in 20 Years, Bernstein's final report on Merrill Lynch. That first article includes the first five guidelines, and in this installment, I will discuss the final five.6. Balance sheets are generally more important than income statements or cash flow. Time and time again, I have about the importance of the balance sheet. As a young auditor many years ago at Price Waterhouse, I learned to focus on the balance sheet as a central part of the company's financial condition. The profit and loss statement is simply a bridge between the balance sheets of the two different periods, while the cash flow statement is simply a reconciliation of cash balances between the two periods. While analysts and the media tend to focus on earnings reports and are all stuck in consensus earnings forecasts, investors are best exploring the balance sheet. If profits and losses are lost, the balanced items will be buried in the balance sheet. Having analysts, auditors and investors focus on WorldCom or Enron's balance sheets rather than their earnings, then fraud may become clearer at a much earlier point in time. 7. Investors should focus strongly on GAAP accounting and should pay less attention to pro forma or unaudited financial statements. Bernstein has a lot to say in his seventh playbook. Let's take a closer look. First, he said that investors should focus strongly but not say exclusively. I interpret this to mean that the emphasis should be on GAAP accounting without neglecting other forms of earnings report presentation, as there may be some benefit, in the slightest, in other accounting interpretations. Second, when it comes to unaudited financial statements, one must be careful. Typically, only annual financial results, not quarterly, are unaudited, but most public companies will have quarterly financial statements reviewed by independent accounting firms before disseminating information to the public. Therefore, at some level, while the largest amount of accuracy will be present in the annual financial statements, we should not dismiss unaudited quarterly reports. When it comes to GAAP vs. pro forma accounting, it's best to understand what the differences are for those two types of accounting styles. There may be some excellent reasons to support pro forma over GAAP for certain companies and under certain conditions. But be careful not to fall into the pro forma accounting trap that hurt so many investors during the tech and internet mania of the 1990s. Investors should be a rare provider of capital. Return on capital is usually the highest in which capital is scarce. The whole point of investing is that it's all about risk vs returns. If everyone is chasing investment opportunities the same, then the possibility of capital than rare. When capital is abundant, then there tends to be a sense of urgency to exert that capital, and returns are pursued. Since capital remains cheap, we will create conditions where excessive speculation runs rampant and potential marginal moronic conditions can be created. When capital is scarce, then opportunities to investors will be attracted to the capital. This allows investors to be much more selective in a variety of larger investment alternatives. Therefore, return on capital returns will tend to be higher as investors separate higher return opportunities from lower return alternatives. 9. Investors should research the financial history as much as possible. I can't stress enough how important these guidelines are. There is a tendency for people to understand the economy and financial markets from just one event or cycle. That was a big mistake. If all you can relate to is technology and the boom and bust of the Internet, then you have an incomplete view of financial history. You have to go back as far as possible to see how the market reacts under the same circumstances. For example, as I wrote just last month, this is not the first major financial crisis the nation has experienced, nor is it the first time the central bank and the U.S. government have stepped in to stabilize and support the banking system. Nor will it be the last. I have lived through two market accidents, in 1987 and 200, but I still read about previous market crashes and always made sure to get advice about older and more experienced investors throughout my investment career. In addition, through my writing and teaching, I also conveyed my knowledge of the history to the next generation of investors. While you can, listen and read what veterans and market historians like Teddy Weisberg, Art Cashin and Warren Buffett have to say. You won't be disappointed. 10. Leverage gives the illusion of wealth. Savings are wealth. I can't agree with this accounting lesson. Think of your wealth as your own private shareholder equity. Every time you save money, you push your net income into your net worth. However, when you borrow, leverage inflates assets and liabilities but has no impact on net worth. Only once you have managed to sell assets, pay off debts and convert profits (after taxes of course) to net worth can you safely say that you have created wealth. As we learned from housing arrests, it's easier said than done. Too many people buy homes beyond their capabilities, giving them the illusion of wealth, only to find out they are worse off now than when they started. In the investment world, one only needs to look as far as long-term capital management, which almost unlimited leverage before it had to be saved by a consortium of banks. That's a big bit of financial history that people should know about. You can read more about it in Roger Lowenstein's excellent book When Genius Fails. (Note: I am an unnamed participant -- good people - in the book.) At the time of publication, Rothbort does not have a position in the a mentioned stock, although the position may change at any time. Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment adviser based in Millburn, N.J., that offers individually managed separate accounts, including exclusive long/short strategies for high net worth clients. He is also the founder and manager of the social networking education Web TheFinanceProfessor.com. Soon before that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building a global equity derivatives business and managing the global equity exchange business from the start. Rothbort previously held international duties in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities. Rothbort holds an MBA in international finance and business from Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is Professor of Financial Terms and Chief Market Strategist for the Stillman School of Business of Seton Hall University. For more information about Scott Rothbort and LakeView Asset Management, LLC, visit the company's website www.lakeviewasset.com. Scott appreciates your feedback; click here to send him an email. The price of West Texas Intermediate crude oil jumped today, 3.1% in afternoon trading, as Hurricane Sally descended on the U.S. Gulf Coast, putting offshore oil production, and dozens of refineries along the coast, at risk. Brent Crude, the benchmark for European oil that plays a major role in setting global oil prices, also rose more than 2% today. Rising oil prices are bringing to oil stocks. SPDR S&P Oil & Gas Exploration & The Production ETF (NYSEMKT:XOP), which tracks oil producers in the S&P 500 Index, rose more than 1% for most of today's trading. Shares of Occidental Petroleum (NYSE:OXY) rose 5.3%, while shares of Matador Resources (NYSE:MTDR) and Devon Energy (NYSE:DVN) rose more than 2% on the news. Picture: Getty Images. The temporary push for oil prices is unlikely to fix the woes of 2020 oil producers has been a brutal year for the oil and gas industry, but especially for independent producers and heavy-handed integrated production majors such as Occidental. The collapse in oil demand and prices this spring left many people exposed to the implications of the oil market that they could not make money. Currently, many investors are hoping that today's surge in crude oil prices will take place beyond the temporary impact of the storm surge for offshore production and refinery activity. That result seems somewhat uncertain and may not be possible in the current environment; simply put, the problem continues to be a weak demand. Last week, U.S. Energy The administration's weekly petroleum report paints a fairly weak picture of muted demand for fuel transportation coming out of summer peaks. The global heavyweights entering the ring The last few days have brought more bad news that has far greater long-term implications for U.S. oil companies. Last week, Saudi Arabia slashed oil prices to Asia and the U.S., aggressively acting to take market share to offset a decline in Chinese crude purchases after second-quarter spending. Pivot to U.S. refineries is critical. Saudi Arabia, with the largest and cheapest oil reserves on earth, has largely ignored the world's second-largest oil consumer in the second quarter. Over the weekend, Libya, which has spent most of the year with almost all of its oil production blockaded by factions fighting for control of the country, announced the reopening of its oil port. The addition of Libyan production, which has been closed since before the coronavirus pandemic, could add another 1 million barrels of oil per day to global oversupply in the coming months. Adding cash-starved Libya to the mix, along with low-cost gorillas in Saudi Arabia that will fight for as much market share as possible, and U.S. oil companies face a tough road ahead. Matador's light footprint has several things in his favor, including hedging just under half of its oil production allowing it to realize $48 a barrel on that oil. Devon is in an enviable position, able to cover its operating costs with oil of about $35 a barrel, and may have the strongest balance sheet in the industry. That would go a long way toward helping both companies drive what could prove to be a brutal remnant of 2020. For Occidental, it's becoming more complicated. The company does have some very low-cost oil production, but its plan has been to rely on crude oil prices at or above $40 a barrel to maintain its production, sell some assets, and start chipping away at massive $36 billion in debt (nearly $5 billion of which it will have to pay next year). So while all three have some advantages in low-cost oil production and hedging, the continuation of weak demand due to the coronavirus pandemic threatens to intensify could result in Saudi Arabia and its OPEC group, along with Russia, fighting over market share, using their price strength to beat U.S. shale at higher prices. If the fight for market share increases, U.S. producers won't be able to compete. Compete.