In the News

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Bananas for oranges and dollars for oil

Dependency means consumers will continue to pay increasing costs for gasoline

By Paul Orfalea and Lance Helfert

A colleague received a very unusual assignment on his first day of law school many years ago. His professor walked into the classroom, set an orange and a black briefcase on a table in front of the chalk board, and gave the following instructions: "Take out a piece of paper, draw a line down the middle of it, and describe the similarities and differences between the orange and the briefcase."

Paul **Orfalea**

The point of this exercise was to distinguish facts from ambiguity, but by changing the briefcase in this exercise to oil, we can demonstrate the important concept of elasticity and the fundamentals of supply and demand.

This demonstration has major implications for our investment strategy, and explains why we currently own multiple oil and natural gas stocks.

What is economics?

In a nutshell, economics is the study of the choices people make in their everyday lives. We have a friend who is just crazy about his health. He is always snacking on fruits and vegetables, and will rarely treat himself to dessert.

A few years ago, the price of his favorite fruit, oranges, went through the roof, and he was faced with a decision. Would he pay double the normal price for oranges or would he switch to apples and bananas? Without much hesitation, he made the switch. Soon after, the demand for oranges fell as more people switched to apples and bananas, and the price of oranges came back down.

Another friend of ours lived in Ventura and commuted to work in Santa

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Heather Hughes / Newport News Daily Press

Oil demand is inelastic because a spike in prices does not reduce demand. Prices will continue to be strong because Americans are gluttonous consumers of oil, according to Paul Orfalea and Lance Helfert.

Issue behind rising gasoline prices lies in consumer behavior

OIL
From D1

Barbara during the late 1970s and early 1980s. She drove a 1968 American Motors Ambassador, which got eight miles per gallon. In 1978, gasoline cost 65 cents per gallon. Our friend figured the $5 commute was well worth the money she saved by living in Ventura.

To her surprise, the cost of gasoline started to climb, until one day in 1981 it reached $1.65 per gallon. At that price, our friend calculated that her daily commute now cost $12.50 per day. She mulled her options and decided that since she didn't know anyone commuting to Santa Barbara, and since the cost of living in Santa Barbara was now even higher, her only alternative was to take the bus, which she refused to do.

Elasticity sounds simple

What can we learn about economics from these two friends? Remember, one likes oranges and the other depends on gasoline. The answer is that people will pay higher prices for oil because they must, but oranges can easily be substituted with bananas.

Similarly, a person stranded in the middle of summer would gladly spend their life savings on water if it were in short supply.

This concept is known as elasticity. It is the degree to which supply, demand and price interact. Oil demand is considered inelastic because changes in its price do not significantly affect the quantity demanded. In addition to gasoline, people depend on oil daily for countless other products such as plastic, pharmaceuticals, asphalt, fertilizer, pesticides, detergents and paints.

Technically, elasticity of demand refers to the degree to which price affects demand and, indirectly, supply. But the three are inextricably linked, particularly when availability is unknown. In the case of oil, we believe prices will continue to be strong for years to come, and we are investing our money accordingly. Consider these factors:

- Demand is growing rapidly in China and India, the world's most populous countries.
- Production capacity cannot be quickly increased, if at all.
- There are no obvious substitutes on the horizon.
- The major source, the Middle East, is politically unstable.
- Estimated reserves may be overestimated and difficult to recover.

here. At what price point would gasoline consumption drop? Would that free up supply for growing economies and extend supplies until viable substitutes are developed?

Governments and private enterprise walk a tightrope on these issues, and it may be political suicide to focus on the real issue — Americans are gluttonous consumers of oil and the worst is yet to come.

Today, consumers complain left and right about the outrageous price of gasoline but in reality it is cheap; too cheap in our opinion. To put this in perspective, at current prices of $2.75 per gallon, gasoline equates to only 34 cents per pint, which is less than the cost of bottled water. (Prices swung wildly last week across the nation because several refineries and oil rigs were damaged by Hurricane Katrina. Ventura County's average price for regular unleaded hit an all-time high of $2.98 on Friday, according to The Star's survey of 10 area stations.)

We believe future generations will look back at our time as the "era of petrochemicals." Serious repercussions might result in the world economy if new technologies are not developed in time to bridge the gap between

For this reason, we should be asking important questions about our future: What would higher oil prices mean for transportation, real estate patterns, tourism and world trade? By investing in select oil production and exploration companies, we are effectively hedging against the possibilities of increasing oil prices, a deep recession and a declining U.S. dollar — since oil is priced in a world market.

Natural gas provides similar opportunity. Domestic supply is declining in spite of major reinvestment, and demand is increasing. Thus, until an Alaskan pipeline and/or Liquefied Natural Gas terminals are approved, funded and built, we believe existing reserves will be quite valuable. Uranium and copper are likewise constrained and their demand is inelastic. The price might go up, but demand will not diminish for the foreseeable future.

Understanding the market

People often assume that we, as long-term investors, prefer companies that produce products which have inelastic demand, but this is not always the case. We are, in a word, opportunistic, so we look for companies that understand and manage the elasticity of their products. Wrigley, for example, brilliantly manages inventory, shelf space and branding, maintaining fairly consistent profitability despite selling a range of products with highly elastic demand.

Likewise, pharmaceutical companies create inelastic demand for a time with patents, but one must watch the clock and the competition. As soon as the patent runs out, substitutes appear and the supply/demand/price matrix finds a new level of equilibrium, at considerably lower margins than when supply was constrained.

The best companies manage their product life cycles to maximize profitability, introducing a new, high margin product just as an older product descends into commodity status.

The interrelationship of supply and demand is the easiest and most intuitive concept in economics, often called "the dismal science." Adding the third component of price introduces subtle complexities, particularly when we step out of the realm of the academic (widgets) and into a world where people's lives and livelihoods depend on allocating resources to make the optimal number of refrigerator compressors, or megawatts of electricity, or doses of flu vaccine.

We do not think there is anything "dismal" or dreary about economics. To us, economics is a beautiful painting of lives touching lives, in endless combinations. We study this painting, admire it, and try to learn what it can teach.

— Lance Helfert and Kinko's Inc. founder Paul Orfalea are the co-founders of West Coast Asset Management Inc., a private independent money manager in Ventura. Orfalea sold his interest in Kinko's two years ago. Vice President Atticus Lowe contributed to this column. Please e-mail questions to info@wcam.com. The principals of the firm or their clients may own shares in the companies they write about.