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Looking at ethanol investments

Automotive pioneer Henry Ford once dubbed ethanol the “fuel of the future,” and predicted it would power the Model T car and its progeny far into the future.

Now, almost a century later, his vision may finally come true.

Ethanol, or ethyl alcohol, is a grain alcohol derived from crops such as corn and sugar cane. While it can be used as an independent fuel source, it is employed primarily as a fuel additive, with the 85 percent ethanol-gasoline blend known as E85 sold in most major metropolitan markets.

Ethanol and ethanol blends offer many advantages over traditional gasoline. Because ethanol is produced domestically, it could significantly reduce our dependence on imported oil. It also tends to burn cleaner than gasoline and other fuel additives like MBTE, thus reducing overall harmful emissions.

Finally, and perhaps most importantly, ethanol is renewable.

These advantages-combined with pressure from the domestic farm lobby-recently spurred the federal government through the U.S. Energy Policy Act of 2005 to mandate an increase in ethanol

production to 7.5 billion gallons annually by 2012.

This federal legislation, as well as similar state and local mandates, has resulted in a huge increase in ethanol production and a correspondingly huge potential investment opportunity.



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Potential pitfalls

First, with new plants sprouting up all over the Midwest, we could see a major glut of ethanol over the

next few years.

For example, there are 119 ethanol plants in the United States with a production capacity of almost 6.2 billion gallons per year. This represents a jump of more than 43 percent just since the beginning of 2006.

More alarmingly, an additional 86 ethanol plants are under construction, which will soon increase domestic production capacity by 6.4 billion gallons per year.

While it is possible demand will keep pace with this meteoric production growth, it is difficult to imagine any

commodity market absorbing a four-fold production increase in five years without some significant hiccups.

Second, corn-based ethanol may soon be supplanted by better, more efficient ethanol inputs like sugar cane, switchgrass, or even algae. For example, cellulosic ethanol made from switchgrass may be six times more energy efficient than corn ethanol and, unlike corn ethanol, actually produces no pollution when burned.

Third, there simply is not enough corn produced in the United States to support widespread adoption of corn-based ethanol as a significant fuel source. And the secular long-term tightness of corn is expected to continue for some time as China, once a large corn exporter, has now become a net importer.

Consequently, it would be a stretch for ethanol to displace more than 10 percent of the 150 billion gallons of gasoline used annually in the United States without significantly impacting the availability of corn as a food source.

Investment options

For investors who want to add some ethanol exposure to their portfolios despite these potential problems, there are several options.

Publicly traded ethanol producers include VeraSun (VSE), Xethanol (XNL), Pacific Ethanol (PEIX), Aventine Renewable Energy Holdings (AVR), and the country's largest ethanol producer, Archer-Daniels-Midland (ADM). And if making bets on individual stocks is not your style,

several exchange-traded funds including the PowerShares Wilder-Hill Clean Energy Portfolio (PBW), PowerShares Wilder-Hill Progressive Energy Portfolio (PUW), and the Market Vectors Global Alternative Energy Fund (GEX) all include ethanol companies in their respective portfolios.

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