



The Bet

Posted by [Robert Rapier](#) on January 2, 2008 - 12:32pm

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While I won my [\\$1,000 bet on oil prices](#) by a whisker, I know a lot were rooting against me. They should be happy to know that [my bad karma is not going to allow me to keep the money](#). So, the lesson I learned years ago is reinforced: Don't bet.

\$100 ?

(*Ed. note: Robert really did miss by a whisker - one trading day - front month crude [touched \\$100 today](#))

Background

In December of 2006, there was a lively discussion here about what would happen with oil prices in 2007. Although almost everyone felt that oil prices would rise, some argued that oil prices would rise to \$100 by the end of 2007. A major reason for this belief was that Saudi Arabian oil production was declining at the time – and many felt like this meant that oil production in Saudi Arabia had peaked.

While I felt that IF Saudi production continued to decline, we would certainly see oil prices go to \$100, I didn't think it likely that they were experiencing involuntary decline. Therefore, I offered to bet \$1,000 that we would not see oil reach \$100 before the end of 2007. I offered this as a single bet of \$1,000, or 10 bets at \$100, or anything in between. For a couple of weeks I had no takers, but then on 12/21/06 (incidentally my 40th birthday) I received an e-mail from someone offering to take the entire \$1,000 bet.

A bit of negotiation ensued to make sure that we were very clear on terms and definitions. The terms of the bet were: If front month WTI reached \$100 at any point in 2007, I would immediately pay off \$1,000. If not, then I would collect \$1,000 on January 1, 2008. We would not complicate the bet by considering a rising or falling dollar. By January 7, 2007 we had each transferred \$1,000 into the PayPal account of [Super G](#).

My expectation was not that oil prices wouldn't go higher. I have invested with the expectation of consistently higher oil prices for the past 5 years. In fact, I predicted to my then boss after oil first crossed \$50 that this move was due to fundamental reasons that were not likely to subside. So I am long-term bullish on oil prices. While I didn't feel that we would see \$100 oil in 2007, I could definitely see that threshold being reached in 2008. As a result, I have consistently turned down offers to bet against \$100 oil for 2008, even during the summer when oil was still trading in the \$60's (about where it started the year). And I wouldn't bet against \$200 oil for 2010.

My Betting History

I have lost two bets in my life. The first time, I was in the 6th grade, and I lost a quarter betting a friend that my elementary school would win a track meet. I can still remember how I felt when I handed him that quarter. The second time was about 10 years later, and cost me a little more money. I bet my best friend that the Broncos would beat the Redskins in [Superbowl XXII](#). We bet \$5 a touchdown, and the Broncos scored a touchdown on their first play from scrimmage. I was feeling pretty good at that point. But it was all downhill from there. The Redskins proceeded to score six unanswered touchdowns, at that time a Superbowl record.

It seemed like karma was trying to tell me something: Don't bet. And that's the primary reason I haven't lost more bets. I simply do not bet. But 20 years after I lost that Superbowl bet, I made an exception this year - the \$1,000 bet that WTI would not reach \$100 this year. Once again, it seemed like karma sent me a warning, as oil came within a whisker of \$100. And while I won the bet, my bad karma won't let me keep that money, as my earlier link indicated.

About My Betting Partner

Many people have asked about my betting partner. He has been silent throughout, but we have exchanged a number of e-mails. So, here are some excerpts about him, in his own words:

I still live, and I still lurk! (I've been an Internet lurker for 21 years; my only Usenet posting was about upgrading the audio circuitry of a Sony DVD player!)

I have to confess that when I agreed to the wager I had no idea what the price of oil would do this year, and as recently as a couple months ago I assumed there would be no chance of a run at \$100 before December.

I tried to bet John Tierney last year that Natgas would go to \$20.00, but he never got back to me. (fortunately, as it turned out).

I'm guessing that between exponentially increasing demand from China/India and exponentially increasing chaos in the Middle East, \$100/bbl should be easy even in the absence of peak oil.

Let panic and chaos in the international oil market begin!

Piercing the veil on the mystery man-I'm a document analyst at Chemical Abstracts in Columbus, OH. If I see a patent from Chevron, Shell, et. al, I transfer it immediately to the petroleum section! [RR note: I deleted one sentence here as it may have enabled him to be identified, and I don't know that he wants that.]

Risk Factors

I identified some risk factors from the start. A continued Saudi production decline would almost certainly lose me the bet. But my belief that the Saudi decline wouldn't continue was the primary driver behind the bet. But there were other risk factors. Here is what I wrote regarding the risk factors:

There are two scenarios in which I could see myself losing the bet. First, if we really are at peak now, and this becomes obvious as demand picks back up, then I could easily lose the bet. The other way is through a series of unfortunate events. If we have a bad hurricane season in the Gulf of Mexico, combined with terrorist attacks or pipeline problems (or any number of things), then I could lose the bet. But I think the odds of either of these is low enough to warrant the risk.

The Hedge

I also identified areas in which I was hedged. I own oil company stock that generally rises with the price of oil. So that's a hedge. And in fact, while oil ended the year over \$90, my company stock appreciated by more than 25% for the year.

Of course if the money was a big issue, I could have made another hedge. I could buy a contract as oil closed in on \$100. If it rose to \$100 from there, I lose the bet but earn money on the contract. If it fell, I win the bet but lose money on the contract. This is a sort of spread strategy I would use if I actually had big money on the line. But I didn't, so I didn't use it.

Investing versus Gambling

From the outset, I said that I invest, but I don't gamble. Without a doubt, skill and luck are involved in both gambling and investing, but gambling is weighted more toward luck. Here is an example of the difference to me. If I make a bet that oil prices will be higher or lower a week from now, per my criteria that is gambling. In the short term, oil prices can easily swing either way. But if I make a bet that oil prices won't rise by \$20 in the next month, that would fall more along the lines of what I consider an investment. The biggest difference there is in the probabilities involved. A bet on a \$20 rise in a month would suggest a significant shift in fundamentals, whereas a bet on up or down in a week does not require that shift. I would probably have a 95% probability of winning straight-up bet on the \$20 rise but only about 50% odds of winning the bet on simply higher or lower prices in a week.

In January of 2007, crude traded at \$60. If you look historically, a move to \$100 in one calendar year would be a very rare percentage move. Therefore, taking history into account, I deemed such a move unlikely. Of course if oil production has peaked, price history is not a useful guide. But in January, the market placed a low probability on oil reaching \$100 in 2007. In a recent e-mail to me, Nate Hagens - who formerly traded for a living - reiterated that point:

I have been very bullish on oil but even I would have made the bet you did - no brainer
- the option vol gave that about 1 in 12 chance of happening when you made the bet...

If I went to Vegas, would they give me even odds if I wanted to bet that oil wouldn't reach \$100 in 2007? Would the market give me those odds? Of course not. But I got even odds on the bet. So, I had history behind me, I was getting lopsided odds in my favor, and I felt very strongly that my primary risk factor – continued Saudi declines - would not go against me. To me, that's a good bet. I don't consider it gambling, because the odds are stacked in my favor.

Now, look at it from the other side. Let's say I am convinced oil will rise to \$100 in 2007. If I am, and the market is suggesting that there are 12/1 odds against, I buy a futures contract, and I make more than 10 times my \$1,000 investment for being correct. Maybe this is why people were reluctant to take the bet - they didn't prefer to give even odds when they could get much better odds in the market. That did occur to me, and would be a very valid reason not to take my bet, even if you were certain that oil would reach \$100 in 2007. Of course my betting partner was aware of the odds, and just saw this as a bit of fun. And if he put a second \$1,000 in oil futures, he is way up even after losing the bet.

I am not risk averse, but I stack the odds in my favor whenever I can. I understand probability and I don't hesitate to put capital at risk if I feel the odds are favorable enough. This is primarily why I don't invest in commodities. The reward is great, but so is the risk. And the time frames are generally not long enough for my long-term strategy. I try to look at fundamentals over a long period of time. I don't buy a stock and sell it next year. I did when I was younger, but too many little losses affected my returns. Now, I buy according to how I see the long-term fundamentals, and if the stock goes down 20% in the next 6 months, I don't sweat it. Exceptions of course being that the long-term outlook has substantially changed.

What Happened

Amazingly enough, none of the risk factors I identified transpired, yet I still nearly lost the bet. Saudi production stopped falling shortly after the bet was made. There were no major attacks on infrastructure, and the hurricane season didn't affect any production for an extended period of time. Instead, there was a rash of other factors.

Primarily, whether you believe OPEC could produce more or not, their foot-dragging definitely spooked the markets. The fact that they waited until late in the year to start increasing production really fuelled speculation that they were tapped out. Worldwide inventories were pulled down in the 3rd quarter, but for the most part they weren't unusually low. They were definitely lower than they were, but they were being pulled down from historically high levels.

The general consensus back in August was that oil might reach \$80 this year, and perhaps \$100 next year. But market sentiment shifted over the next 3 months. I think the [ASPO conference](#) in October really raised Peak Oil awareness. There were more references to Peak Oil in the media. It seemed that a critical mass shifted toward the view that we have peaked, or are near peaking. And once widespread realization of Peak Oil hits the markets, \$100 oil will be cheap.

As market sentiment was shifting, there were a series of bullish events. For a while, it seemed as if every piece of news favored higher oil prices. Interest rates were cut. Prices spiked. U.S. inventories had some surprising crude draws. Prices spiked. Mexico had to halt production due to

a storm. Prices spiked. Each week there was a new event that contributed to another \$3-5 spike. OPEC continued to insist that there was nothing they could do, as “the spikes were not based on supply and demand.” Of course if they had the production to spare, it doesn’t take a rocket scientist to see that they could have cooled off the markets by putting more crude out there – whether or not they thought it was needed. Oversupply the market, and prices come down.

The net result, regardless of the cause, was that front month WTI topped out at \$99.29 on November 21st. I maintained at that time that I did not believe that price was sustainable in the short term, and even if prices topped \$100 I thought they would give up at least \$10. Why? Not because I don’t think oil is intrinsically worth \$100. No, the reason I think \$100 was overextended at that time was that 1). I didn’t believe the fundamentals had dramatically changed enough over 3 months to justify a 30% run-up; 2). I felt that OPEC had some spare capacity that they could bring on in response to higher prices; and 3). The market had not had time to absorb the impact of higher prices on demand. This latter point is important, because we did see signs of demand destruction – which you would expect – at these higher prices.

The [IEA started revising their demand projections downward](#), and at the same time OPEC started pumping more oil. This did impact prices as I had expected – they corrected down to about \$88 before making another run at \$100 late in the year.

So, while I came within a whisker of losing the bet, and the outcome was still uncertain right up to the end, following the closing on New Year's Eve my opponent wrote to me and conceded the bet:

Hi Robert,

I hereby concede.

At this point I'm left only with the faint hope of skyrocketing natgas prices to soothe my battered investor's psyche.

Have a great new year!

What to Expect in 2008

I think there are a lot more uncertainties than there were a year ago. To me, there are a few questions. First, how will oil prices hovering around \$100 affect worldwide demand? I don't think we have had enough time to gauge that. Second, can OPEC bring on more production if demand does continue to grow? Bottom line, I am not making any predictions for 2008 as I think the demand question is a real wild card. I do expect that we will go ahead and crack \$100, and if demand is not significantly affected by \$100 oil, then it will probably advance another 20-40%.

But, no more bets from me. As oil closed in on \$100, I was actually waking up during the night and checking on oil prices. I was dreaming about oil prices. But, now that 2007 is over, I say "Bring on \$100 oil", as I think this is the only way we are going to stretch out our oil supplies by getting people to conserve.

Happy New Year to all, and best wishes for 2008.



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