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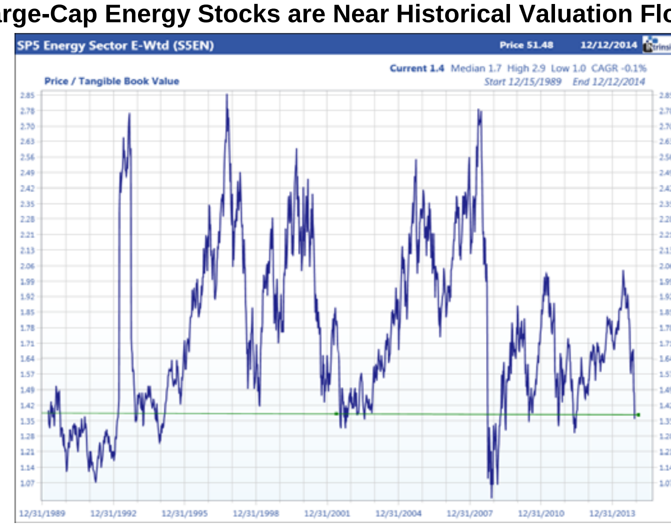
Energy: Pessimism Pervades, Negative Catalysts Nearing Exhaustion

One truth about investing: You can either have good news or good prices, but you will rarely have both. Nowhere in domestic equity does this ring truer today than in the energy complex, where the news has been generally awful, but the prices ("values") appear to be relatively attractive. We believe that this creates a window of opportunity for the long-term investor who is willing to live with some short-term volatility in order to gain exposure to energy-sensitive companies at extremely discounted prices. Over the long run, we believe the natural balancing mechanisms that have been present for decades will eventually reassert themselves, bringing energy supply into balance with energy demand and ultimately putting a floor on oil prices and energy stocks.

The investment graveyard is full of smart people who failed to accurately predict oil prices. We are not foolish enough to think we are smarter than they were, and we have no intention of adding our name to one of the headstones. However, we think there will come a time when large-cap energy companies incorporate a "worst case" scenario in their stock prices, and we believe we are within 10% of that point now. Our conviction comes from the chart below, which shows that S&P 500 energy companies are now trading at a price-to-tangible book value levels that have historically provided a floor to their stock prices. As long as the risk of a global depression or major US economic slowdown remains unlikely, we do not believe energy stocks will test the "extreme" valuation levels seen in 2008 or 1989. This *Equity View* focuses on the implications of the 46% drop in crude oil prices since mid-June and the opportunities and obstacles it could potentially present to our portfolios.

Large-Cap Energy Stocks are Near Historical Valuation Floors



Source: Intrinsic Research; past performance is no guarantee of future results.

Low Oil Prices Bring More Good Than Bad

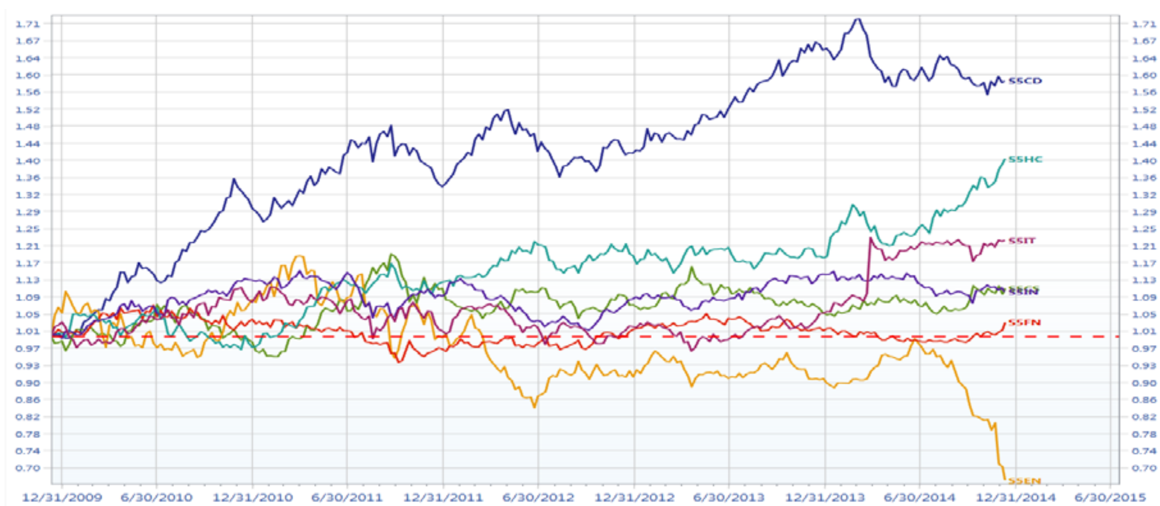
Make no mistake — far more people and businesses benefit from low energy prices than suffer. Oil touches nearly every part of our lives. Cheaper gasoline and heating oil will be a rebate to nearly every consumer; while less expensive diesel, jet fuel, and petroleum by-products will reduce the cost of nearly every good being sold in stores. Below is a list of some beneficiaries of low oil prices that we like:

- **Consumer-Related:** Less money to fill the gas tank means more money for discretionary spending. We believe all consumer stocks should benefit, but businesses that produce goods and services for consumers at the low-end of the income scale should experience the greatest boost, since these were the consumers most affected by high energy prices. Industries that could benefit include: dollar and discount retailers, casual dining, supermarkets and drug stores, packaging companies, credit card companies, and teen retailers.
- **Transport-Sensitive:** Users of energy will be obvious beneficiaries, since lower gasoline and diesel prices will have a direct positive impact on profitability. Additionally, companies that benefit from a rise in the number of miles that are driven should also be positively affected. Industries that could benefit include: trucking, airlines and airfreight, auto parts, and auto repair.
- **Energy-Importing Countries:** Many countries outside the US, particularly in Asia and Europe, are energy importers. Falling oil and gas prices should be welcome relief to countries such as China, Japan, and Korea, which have seen margin pressure on their exports when their energy costs were rising. As most of these countries are also leading producers of consumer goods, the plunge in oil prices should be a double benefit if consumers spend what they save at the pump.
- **"Easy Money" Countries:** For countries whose central banks have implemented easy monetary policy (low rates and/or quantitative easing), falling energy prices should keep inflation in check, which should allow the central banks to be more stimulative for longer. Countries that could benefit include: United States, Japan, and most of the countries in the European Union.

Energy Stocks Have Already Discounted A Large Amount Of "Bad News"

It is important to recognize that energy stock prices will likely bottom before energy news does. The market has already discounted a substantial amount of bad news in the prices of energy stocks. The energy sector was already the worst-performing sector in the S&P 500 over the past five years, even before the dramatic plunge in crude oil. Since June 30, S&P 500 energy stocks have underperformed the broader market by an additional 30%.

Chart: S&P 500 Sector Relative Performance



From a five-year relative performance perspective, Energy has been the worst-performing sector by a wide margin.

Key:

SSCD: Consumer Discretionary
SSHC: Healthcare
SSIT: Technology
SSCS: Consumer Staples
SSIN: Industrials
SSFN: Financials
SSEN: Energy

Sector Constituents are Equally Weighted

Weekly Price Relative to S&P 500 Cumulative Growth Comparison
Source: Intrinsic Research; past performance is no guarantee of future results.

But, Energy Stocks Are Still Trading On Headlines

We recognize the wisdom in the old adage, "Don't try to catch a falling knife," and we are reluctant to call a bottom in oil prices or oil stocks today. Over the next few months, there will likely be a steady drumbeat of bad news for energy stocks as cap-ex budgets and analyst estimates get revised down to catch-up to current crude prices. This will be a headwind for energy stocks despite their attractive valuations, and we will be looking for the moment that energy stocks begin to look through the bad news. That means that, eventually, we will need to begin building positions in energy-related companies while the news is still bad. As of today, it does not appear that we are there yet. Energy stocks continue to fall in lock-step with crude prices, which means that the market is not yet ready to look beyond the negative headlines, in our view.

While We Wait For A Buying Opportunity, We Prefer Owning Infrastructure Assets (Oil And Gas Pipelines)

In our view, energy infrastructure companies, such as those often structured as Master Limited Partnerships (MLPs) or pipeline C-corps, represent our favorite vehicle to own while we wait for oil prices and oil stocks to find their bottom for the following reasons:

1. **Get paid to wait:** On average, high-quality pipeline companies pay distribution yields of 4-7% annually; those distributions have historically grown about 8-9% each year. While we would not be surprised to see the rate of growth in distributions slow in coming years if oil prices stay low, we do not anticipate any cuts in distribution rates for the high-quality MLPs.
2. **Investment grade balance sheets:** A 40% drop in crude in less than six months will cause significant pain for many energy companies, particularly those with high leverage and significant commodity sensitivity. Some of these companies will not be able to survive and will be forced to sell out to stronger competitors at “fire sale” prices. For this reason, we like the high quality pipeline companies whose investment grade balance sheets should provide them the “dry powder” to take advantage of the bargains that are likely to come.
3. **Least amount of commodity sensitivity**: The majority of the energy infrastructure companies we own collect “tolls” for processing and transporting petroleum products from one part of the country to another. Whether oil is $100 or $50 a barrel, gasoline and natural gas will still need to be moved from Texas to Boston and all points in between. This means that energy infrastructure companies have significantly less exposure to the *price* of crude or natural gas than most of their non-infrastructure energy peers.

The Down-Trend In Oil Prices Is Logical; It’s The Magnitude That Is Hard To Gauge

Energy prices are governed by the laws of supply and demand. Consequently, the unwillingness of Saudi Arabia to reduce supply in the face of slowing demand was the catalyst for the current downturn in prices. However, following such a sharp decline in prices, we believe supply is near its peak and demand is about to bottom out.

Approaching Peak Supply:

- **North American energy production has been running flat out:** The technological advances of horizontal drilling and fracking, combined with $100+ per barrel oil prices and cheap, readily available capital, has created a temporary supply glut in the US. Until recently, energy companies have had few incentives not to be conservative in their exploration and extraction activities; now they have several.
- **OPEC production has also been prolific:** Rarely have we seen a time when so many OPEC countries have been producing at capacity combined with a near-universal agreement not to throttle back production in the face of significant declines in crude prices. Ironically many oil-producing countries are not profit maximizers. They need the revenue to pay for government spending; thus, they will not respond to falling prices by cutting production. The exception is Saudi Arabia, which will seek to find the price that inflicts maximum pain on their competitors and enemies, but it ultimately wants the highest possible price for its large, but dwindling reserves.

Near A Trough In Demand:

- **US economic growth has been slow:** With the economic recovery in the US progressing at a slower than desired pace, energy demand growth has not been sufficient to offset the massive increases in energy supply. Without the legal ability or infrastructure necessary to export oil, US energy companies are “price takers” that have little flexibility in the decision concerning where to sell their crude.
- **Europe has been flirting with recession:** With the world's second-largest economic block bordering on recession, oil consumption in the Eurozone has been soft.
- Restrictive fiscal and monetary policies across the emerging markets have slowed their economic growth, which has had a negative impact on energy consumption.
- We have been in the “shoulder” season for heating and cooling over the last three months. The mild temperatures that typically occur in the fall lessen the need for energy to heat and cool our homes and businesses.

Low Prices Should Bring Supply And Demand Back Into Balance

Supply Will Fall From Peak Levels

- North American energy companies will likely throttle back production as low prices discourage exploration and production activity and capital becomes more scarce and expensive. This is already occurring as several major energy companies have cut their capital expenditure budgets for 2015 by 10-15% (according to Jefferies), and we expect US rig count to drop 15% in 2015. US drilling permits are down 35% month over month.
- OPEC will have difficulty maintaining allegiances: Lower energy prices will ultimately lead to increasing budgetary pressures on the governments of oil-exporting countries, causing increasing civil unrest. Left unchecked, this civil unrest has historically led to unstable and declining levels of OPEC oil production.

Demand Will Not Remain At Trough Levels

- **US economic growth will accelerate, in our view:** Slowly, the American economy appears to be awakening, as was evidenced in the most recent payroll numbers. Rising employment, rising wages, and a recovering housing market mean more workers will be driving to work and will likely have more disposable income. We believe the significant drop in gasoline prices will cause an increase in demand as people drive more. Already the US is seeing a change in the car-buying mix towards less fuel-efficient SUVs.
- **Europe will eventually come out of recession:** The magic elixir of low interest rates and monetary stimulus that brought the US economy out of recession, should eventually have a similar effect on Eurozone economies. When that happens, oil consumption will rise again as consumers and factories need and can afford more oil.
- **Central banks across the emerging markets will take their foot off the brake:** This has already begun to occur in many of the emerging Asian economies, such as China and India. With many of these countries accounting for the lion's share of marginal demand growth for oil and gas, they are an important component of putting a floor on oil prices.
- Winter will bring colder temperatures and, therefore, rising demand for energy.

In conclusion, oil is going through a significant price decline. The geopolitical fear premium has been eradicated, and the bears and momentum traders are currently in control. Analysts are rushing to build current prices into earnings forecasts, and energy stocks are falling in line with oil prices. At a time like this we can't be complacent about the short-term risks, but we know from history that major price moves do not occur in a vacuum. In a nut shell: we think the best cure for low oil prices is low oil prices.