

MARKET COMMENTARY

Tetrem Capital Partners, October 2004

Arguably the most significant investment story thus far in 2004 has been the unrelenting rise in the price of oil. The daily high closing price for oil was a few cents shy of \$55 on October the 15th. Oil has risen 69% so far in 2004. In the words of my two-year old son Spencer “what just happened?”

...demand for oil has been on a steady rise...

In fact, many things have happened.

The demand for oil has been on a steady rise while supply has been running into severe constraints. For the first time in many years we are going through a global synchronized

China...with India...both have a voracious appetite for fossil fuels...

economic recovery. China is leading the way with India not far behind. Both have a voracious appetite for fossil fuels of all sorts as they industrialize, build infrastructure and move forward to achieve the American Dream of a consumer society. Developed economies are more efficient users of oil than they were in the 1970s, but they too have driven up demand. The proliferation of SUVs and muscle cars has not restrained our thirst for oil.

On the supply side, there is simply less of the slick stuff. Let's not forget that oil is a finite resource that is burned. Existing oil wells are depleting, while new ones are more expensive and difficult to discover. New technologies helped increase supply and put downward pressure on the price of oil through most of the 1980s and 1990s. These new technologies have increased supply mainly by “squeezing” greater amounts of oil from existing wells, and helping to find and develop new small oil fields. However there is only so much juice that can be squeezed from any orange, while small oil

Existing oil wells are depleting, while new ones are more expensive and difficult to discover.

finds are a less significant source of supply in a world that burns 80 million barrels per day.

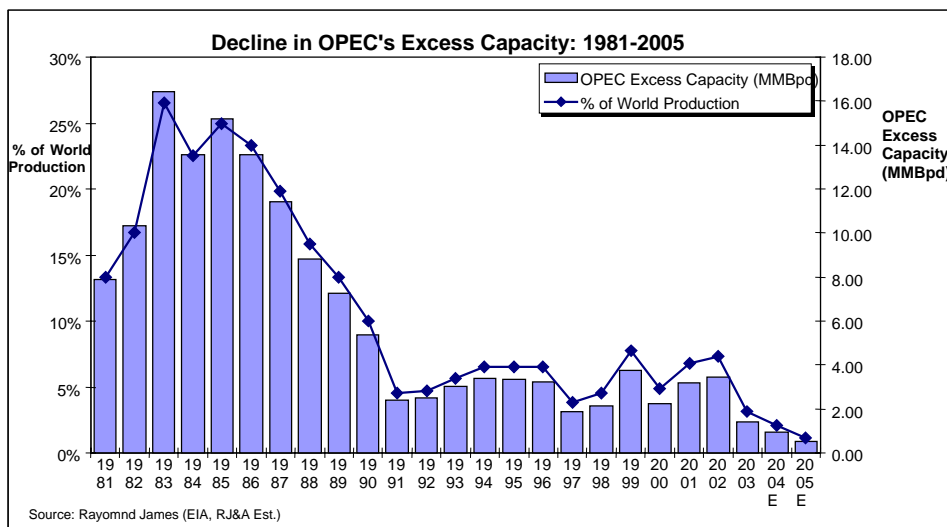
Professional managers who are focused on return of capital are now running the oil companies. They have forsaken their wildcatting pasts. They have become disciplined guardians of capital. This is great for shareholders, but isn't likely to keep oil prices down. Past oil spikes were caused by supply shocks such as the Arab oil embargo, the Iranian Revolution and Saddam's invasion of Kuwait.

Supply is so tight that OPEC has all of the world's excess capacity, and all of that excess capacity lies within Saudi Arabia.

This time around, the price of oil has gone up while supply has actually increased. The crux of the problem is that demand has finally caught up with supply.

At first, market pundits blamed the rise in oil on a “terror premium”, and as of late the blame has gone to the speculators. Undoubtedly both have contributed to push prices even higher in this fertile environment of tight supply and demand.

Today, supply is so tight that OPEC has all of the world's excess capacity, and all of that excess capacity lies within Saudi Arabia. The chart below indicates that excess OPEC (Saudi Arabia) oil capacity is now at less than one million barrels per day. This represents less than 1% of world oil production. If we lose one million barrels per day of oil supply, global oil demand will not be met at current prices. It seems that a terror premium is warranted when supply and demand is so tight. Speculators are aware of these issues and are therefore participating in the pressure on oil prices. However, the “terror premium” and speculators only matter when the balance of supply and demand is as tight as it is today.



The world is an exciting and new place for my two-year-old. Spencer is constantly amazed by “what just happened”, but in the world of investing our job is to anticipate what might happen. At Tetrem we don’t speculate in oil or any other commodity. We believe that the current environment favors higher oil prices than existed through the 1990s when oil largely stayed in an \$18 to \$25 range. An environment of sustainable higher oil prices is great for the energy sector and the energy companies in which we invest.

We believe that the current environment favors higher oil prices than existed through the 1990s...

We have been overweight the energy sector in the portfolios that we manage since oil bottomed in 1998 at close to \$10 per barrel. At that time, we identified dirt cheap valuations in an industry starved of capital – the exact opposite of what was happening in tech land.

Whereas tech stocks were being created out of thin air and were gobbling up billions of investor capital to create new ways to sell pet food over the Internet, oil companies stopped spending on exploration as they sought ways to maximize return on invested capital. With these contrasting uses of capital, economic forces were getting set to punish the wicked (tech companies) and favor the good (oil companies).

In a market environment where it is difficult to find value, oil companies appear to be a good place to be invested.

Being an energy bull for the past six years has not been a smooth ride (when is the ride ever smooth in the stock market?), but it has paid off handsomely. Our bullish view of Oil and Gas companies has not changed. The stocks are not as cheap as they once were, but the commodity price environment is much stronger. Oil at \$55 may be too high, but it may be too low. Our portfolio of oil stocks is valued as if oil were in the low thirty-dollar per barrel range. These companies continue to look appealing in our quantitative work on both relative valuation and capital discipline measures. In a market environment where it is difficult to find value, oil companies appear to be a good place to be invested.

For some time now, we have felt that energy stocks were going to lead the market in the aftermath of the bursting of the technology bubble. So far this has been the case and we expect this secular trend of energy outperforming the market to continue, albeit in its usual choppy fashion.

Back in the late 1970s (the good old days for oilmen) ‘Dallas’ ruled the television airwaves and energy companies made up nearly 25% of the S&P 500. Oil firms were the technology companies of their day and they followed down the same path to self-destruction. It took twenty years for the industry to move beyond the accumulated excesses of those heady days. The energy sector bottomed at less than 5% of the S&P 500 in 1999 and is currently at 7.5%. While it’s unlikely that we will be going back to anywhere near 25% again, the energy weight within the S&P 500 is headed higher.

Normally, the biggest risk to the continued out-performance of energy stocks is demand destruction in hydrocarbons. The irony is that demand destruction is most likely going to come from a slowing global economy thanks to, yes you guessed it, high oil prices. However, Alan Greenspan recently predicted that the current level of high oil prices would not put the U.S. economy into a recession. In essence, he downplayed the risk of demand destruction at current oil prices. If Mr. Greenspan is right, then oil stocks are headed significantly higher.

When we began purchasing oil stocks back in 1998 people wondered what we were doing. The consensus view was that there were excessive supplies of cheap oil available, OPEC was a basket case and the energy business was a bad business. Except for perhaps one of these points (about OPEC), this is no longer the consensus viewpoint. As contrarian investors, we must always be vigilant when interpreting a change in the consensus outlook. If everyone is long oil stocks, where will the marginal buyer come from? Primarily for this reason we will be looking for opportunities to take some profits out of the energy sector. The energy sector has been good to us, but as a result of its out performance our exposure to it has continued to grow. We want to limit that growth from here. While we may be limiting exposure we are not getting out. We plan to maintain investments in energy companies at a level that is greater than the market for the foreseeable future.

As contrarian investors, we must always be vigilant when interpreting a change in the consensus outlook.

When will we reduce our exposure to energy companies to below market levels? Most likely it will be when we begin to see signs that the giddiness of the good old days has returned. When valuations become truly extended and the oil companies themselves lose their discipline it will be time for us to exit stage left. Maybe the first sign of the top will be the making of Dallas, The Movie.



Danny Bubis, CFA

