Smith Group
ASSET MANAGEMENT

# Market Perspectives Excerpt

## Elusive Energy Differentiation

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JULY 2011

For most of 2010, the price of crude oil was on cruise control, trading in a comfortable, unremarkable range around $70 before gradually rising into the $80s in the fourth quarter as economic optimism grew. So far 2011 has been anything but comfortable for the oil markets, as opposing forces have thrashed the commodity in one direction and then the other, and the risk trade has flitted from on to off to on again.

Middle East turmoil at the beginning of the year sparked an overall rise in investor anxiety and real supply disruptions. This was quickly offset by demand disruption courtesy of the Japanese earthquake/tsunami. Lower growth projections from the Fed and an end to the liquidity injection of QE2 are now weighing on oil prices, while the IEA's announcement of a release from Strategic Petroleum Reserves (about a 2.5% increase in global supply) was a supply shock to the market.

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Longer term, fundamentals supporting the bull case for oil are still intact. In fact, the IEA just increased its global demand projections for both oil and natural gas for 2011-2016. But the picture over the next 6-12 months as to the direction and magnitude of price changes is not clear. Currently oil is trading at $93/bbl, down $20 from its end of April peak. What will the next move be? The most likely scenario is upwards, but the only certainty seems to be continued volatility.Longer term, fundamentals supporting the bull case for oil are still intact. In fact, the IEA just increased its global demand projections for both oil and natural gas for 2011-2016. But the picture over the next 6-12 months as to the direction and magnitude of price changes is not clear. Currently oil is trading at $93/bbl, down $20 from its end of April peak. What will the next move be? The most likely scenario is upwards, but the only certainty seems to be continued volatility.

**Yet, we are not in the business of predicting oil prices.** At Smith Group we do not purport to have the ability to predict commodity prices. **Our focus is on finding companies with unexpected and/or undervalued sources of growth.** While nearly all energy companies are positively correlated to the price of oil, we look for company-specific factors providing competitive advantages over peers. This produces an earnings growth benefit, which should lead to positive relative performance to what pure sensitivity to the commodity implies.

For example, Helmerich & Payne has a differentiating factor via industry leading technology in a product category that is in high demand. The company's top-drive, high horsepower Flex Rigs are ideally suited to drilling in the unconventional plays that are being so intensely developed in the U.S. now. That is coupled with high potential to leverage the same demand internationally. The Great Recession was actually a great stress test of this advantage when Helmerich & Payne maintained higher rig utilization and a lower drop in margins than any of its peers.

For Occidental Petroleum, that difference is a slower reserve decline rate, low cost asset base diversified across the U.S. and internationally, with significant upside potential from the company's Sacramento Basin properties in California. The company has higher leverage to oil vs. gas than peers and higher profitability that peers. This is coupled with attractive valuation metrics.

Our primary objective for stock selection in the energy sector, as it is for all sectors, is to find sources of unexpected growth at the most attractive prices, and we will continue to do that, irrespective of the next tick up or down in oil prices.