INVESTMENT STRATEGY UPDATE

September 29, 2006

ENERGY STOCKS – HOLD ’EM, FOLD ’EM, OR RAISE THE ANTE

One of the biggest investment stories of the past twelve months has been that of energy. The rapid growth of demand from emerging Asia, political uncertainty in the Middle East, and the impact of the devastating hurricanes of 2005 on the U.S. energy infrastructure all combined to effect a significant increase in energy prices. Thus, it was not surprising that as of our June 26 quarterly update, energy was the top-performing stock market sector, year-to-date. But that is not so anymore. After a tremendous bull run in both the energy-related commodity prices and the stocks that directly benefit from them, the sector has undergone a sharp setback. In fact, as we go to press, the energy sector is essentially even with the S&P 500 for the year. So, this seems an opportune time to consider BTR’s stance on energy. Should we turn our backs on the sector or use the weakness to increase our investments?

The Bull Case – Divergence in the Supply/Demand Trends

Rapidly growing Asian demand has been used as an argument for robust long-term growth in everything from refined copper to razor blades, but that doesn’t make it inaccurate. Ultimately, there is no bull case for energy stocks if the demand for energy does not grow. It will grow of course, but the question is, how fast? The industrialized nations account for 45% of world oil consumption, and their consumption is growing at close to 1% per year. Consumption in China, meanwhile, is growing at more than 7% per year and currently approximates 10% of the global total.

Rising demand creates a strong argument for continued high energy prices, but perhaps even more compelling is the lack of materially increasing supply. Normally, when the price of goods increases, producers tend to make more of those goods available to consumers. Yet that hasn’t been the case with oil this decade, despite the fact that the price of oil is now three times the 2002 price of $20 per barrel. At first, as the price of oil rose, supply growth did accelerate. But since late 2004, when oil was still in the $30 price range, the growth in supply has actually decelerated. In fact, for most of 2006, growth in the supply of oil has been below worldwide demand growth.

This slowing supply growth is not due to lack of effort. Currently, the worldwide drilling rig count is higher than it has been in more than ten years. Part of the problem is that, unlike commodities such as timber or corn, once a barrel of oil or a cubic meter of gas has been burned, it’s irreplaceable. After more than a century of drilling, the easy to find, easy to produce oil and gas fields have been tapped. More and more, what’s left is extremely hard to get to, for one reason or another. Sometimes it’s the remoteness or difficulty of the

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drilling location, sometimes it's the cost or availability of the drilling equipment and related services, and sometimes it's the lack of qualified personnel. A recent *Wall Street Journal* article pointed out that Iraq has lost two-thirds of its senior oil executives since 2003. Similarly, the firing of 19,000 striking Venezuelan oil workers by Hugo Chavez has resulted in decreased production. In neither country is production back to pre-2003 levels. In Iran, production is still below pre-1979 levels.

As of March 2006, the international backlog for a certain type of drilling rig called a "jack-up" was more than 100% of 2006 capacity and more than 90% of that projected for 2007. In the deep-water market, the issues are the same. Earlier this year, Global Santa Fe signed a seven-year, $1 billion contract to operate a highly advanced drilling rig that is not slated for delivery until 2009. While the day rate of $390,000 on the contract is far from a record, the term is particularly long, which indicates that at least one producer is confident that energy prices will stay high for some time to come.

Capacity constraints also exist once oil is out of the ground. It has to be refined, and that is yet another source of concern. Much of the world's currently available supply of crude oil is "heavy" and/or "sour." These types of crude require more processing to turn them into useful fuels. Much of the necessary complex refining capacity in the world is located in the U.S., and a big chunk of that is on the Gulf Coast, a region highly susceptible to hurricane damage. While projects are ongoing around the world to increase complex refining capacity, there is much further to go. In the U.S., 70% of refineries can handle heavy or sour crude, and yet clearly our capacity is so tight that any disruption can significantly impact retail prices. Outside the U.S., only 26% of refining capacity can handle these types of crude.

And what about natural gas? It is a meaningful component of global energy demand for both home heating and electricity generation. Although North America is currently self-sufficient in natural gas, imports will need to increase in order to meet future demand growth. The problem with importing natural gas is that it is not as easily transported as oil. It must first be super-cooled and condensed into a liquid for transport, and then re-gasified at a terminal tied into the local market's pipeline system. While there have been dozens of re-gasification sites proposed, few have received Federal Energy Regulatory Commission permits. The "not in my backyard" attitude is at least partially responsible and not likely to change.

A warm 2005-2006 winter resulted in a glut of natural gas in the U.S. that has lasted for most of 2006. But this summer's hot weather actually resulted in the first-ever weekly summer withdrawals from inventory. By the time this winter rolls around, natural gas inventories should be closer to normal levels. And, if we were to experience a colder-than-normal stretch this winter, there could be another price spike in 2007.

Finally, a few words about coal. Although there are no coal-powered vehicles, we must not forget that this is an extremely important fuel for utilities, accounting for approximately half of U.S. electricity generation. This preeminent position is because coal is generally the cheapest and most reliable source of fuel, and coal reserves are quite abundant in North America. While it is true that coal is a dirtier fuel than natural gas, new technologies allow for cleaner-burning coal plants. As such, it is likely that almost all new power plants that will come on line in the next ten years will be coal fired, which certainly argues for increasing demand.

The Bear Case – Never Say "This Time It's Different"

If there is anything investors should have learned from the Internet bubble, it is never to say, "this time it's different." Yes, circumstances change, but energy stocks have always been and will always be cyclical. Those who are bearish on energy believe that the energy stocks will continue to decline, for three reasons: demand will not grow forever at current rates, technology will help increase supply and the viability of alternate sources of fuel, and speculators and hedge funds will drive commodity prices down, just as they drove them up.

The bears argue that higher energy prices will inevitably lead to demand destruction. Higher prices at the pump will certainly impact the demand for discretionary consumer items. If consumer demand drops, global economic growth will slow, and income and energy demand will slow along with it, both here and abroad. Furthermore, a growing number of the emerging Asian nations, including China, are becoming increasingly concerned by the environmental and health consequences of industrialization. In response, these countries are pursuing efforts to conserve energy, including cutting subsidies and making energy efficiency a priority in future development projects. As a consequence, consumers around the world are being hit by higher prices, which is already resulting in slower demand growth.

Regarding the supply of energy resources, the bears argue that high commodity prices and constantly improving technology make once-inaccessible reserves accessible. Additionally, despite the seemingly endless problems in places like Iran and Nigeria, other oil-producing countries have been picking up the slack. Saudi Arabia is relatively stable and still possesses the largest pool of potential surplus oil. And Russia has recently surpassed Saudi Arabia as the world's largest producer of oil. Even in the U.S., the Barnett Shale in Texas and a very recent discovery in the deepwater Gulf of Mexico represent new supplies of oil and natural gas. As for the supply of refined products, the bear camp suggests that enough complex refinery capacity will come on line within a year to allow prices to drop throughout the supply chain. Furthermore, the U.S. is just emerging from the disruptions caused by the nearly simultaneous switchovers from MTBE to ethanol as a gasoline additive, and from standard to ultra-low-sulfur diesel.

Finally, it is commonly believed that a large portion of the rise in commodity prices over the past two or three years is a result of financial market factors. These include the establishment of commodity-specific funds that artificially increased both physical and financial contract demand, and the growing trading volume of hedge funds that sought to mine profits wherever they could find them. The billions in losses recently generated by the MotherRock and Amaranth hedge funds as commodity prices fell, served as a reminder of the extreme leverage employed by many hedge funds. Further fallout could hasten the run for the exits and exacerbate any trend of falling energy-stock prices.

Where We Stand – Of Tides and Waves

At BTR, we are committed to "investing," and by our definition that requires a willingness to sometimes suffer shorter-term disruptions in order to capture the longer-term trends. We know that energy prices are cyclical and will remain so. And we realize that the rate of growth of energy usage will be diminished by rising energy prices and/or global economic weakness. Furthermore, significantly higher prices will fuel the fervor to profit by increasing the supply.

But those will be the waves in what we consider to be a significant longer-term tidal shift. Even if the growth in developing-world per-capita demand does begin to slow, there is still an enormous gap in energy usage. In China, for instance, per-capita oil consumption is still less than one tenth of that in the U.S. Tens of millions of emerging-nation residents will achieve middle-class status in coming years. With more spendable funds, this growing population is highly likely to covet the goods and lifestyles of other prosperous peoples.

We expect that government subsidies and higher energy prices will increase the viability of alternative sources of energy, be they ethanol, hydrogen, wind, or solar. But the significant adoption of these sources of power is still many years away and will require even higher energy prices in order to become commercially viable. Sustainably high energy prices will also prove necessary with regard to any meaningful increase in the supply of the currently produced fossil fuels. Consider the vast potential supply of oil from the Canadian tar sands. While the technology exists to exploit this resource, it is still only economically producible at a reasonably high oil price. And the lower prices go, the greater the proportion of the potential supply that will return to uneconomic status. Even those analysts who argue for moderating energy prices see a probable floor on oil of around $50.

It is also noteworthy that among BTR Capital Management's largest energy positions, valuations are quite reasonable. Absolute and relative P/E ratios, as well as P/E-to-growth ratios, are all below their ten-year averages and in some cases are at or approaching ten-year lows.

In summary, there are valid points within the bear case, but we believe they are short-term in nature. While we took some profits earlier this year, we remain convinced that maintaining a meaningful exposure to energy stocks over the long term will prove beneficial to our client portfolios, and we plan to use weakness to add to holdings.

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