

**INDUSTRY RESEARCH INSIGHTS: ENERGY** **APRIL, 2008**

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**GENERAL OUTLOOK – TECHNICAL INDICATORS**

- **Stock prices continue to reach new highs, on the heels of record oil prices.** The sector had a chance for correction based on demand destruction and clear signs of recession, but ignored it, whether due to supply constraints, geopolitical concerns, dollar weakness, and/or global commodity-based leadership. Overseas demand remains strong (particularly from emerging markets), despite downward revisions to expected global growth. Nonetheless, the position is not without risk and prices remain vulnerable to a pullback, as crowd sentiment is at a record extreme according to Ned Davis Research.

Table I (1)

<p><b><u>Sector Positives:</u></b></p> <ul style="list-style-type: none"> <li>▶ Dollar weakness beneficiary long-term</li> <li>▶ Long-term global commodity-based leadership</li> <li>▶ Record oil prices</li> </ul>	<p><b><u>Sector Negatives:</u></b></p> <ul style="list-style-type: none"> <li>▶ Slowdown in U.S. and global demand</li> <li>▶ Longer-term Mean reversion potential</li> <li>▶ Over-owned</li> <li>▶ Adequate inventories</li> <li>▶ Crowd sentiment</li> </ul>
<p><b><u>Sub-Industries:</u></b></p> <p><b><u>To Consider</u></b></p> <ul style="list-style-type: none"> <li>▶ Oil &amp; Gas-Exploration &amp; Production</li> <li>▶ Coal &amp; Consumable Fuels</li> <li>▶ Oil &amp; Gas-Drilling</li> </ul>	<p><b><u>Sub-Industries:</u></b></p> <p><b><u>To Avoid:</u></b></p> <ul style="list-style-type: none"> <li>▶ Oil &amp; Gas – Refining &amp; Marketing</li> <li>▶ Oil &amp; Gas – Storage &amp; Transportation</li> </ul>

- **Oil prices have climbed to yet another record high above \$125/barrel in early May, supporting Energy stocks.** Perpetual crude oil pricing and long-dated contracts confirm front-month prices. Continuing geopolitical tensions are key issues supporting prices. Strong overseas demand, particularly from China, India, and other emerging markets, also continues to support the sector. Despite high prices and the probability that the economy will brush with recession, U.S. demand growth has remained resilient, although it is once again beginning to slow. Stock levels remain adequate, with the exception of distillate inventories.

1) Intra-sector recommendations from Ned Davis Research based on macro industry outlook (top-down macro-economic factors), trend-sensitive

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- **Nonetheless, prices remain vulnerable to a pullback**, as crowd sentiment and the 13-week rate of change in perpetual pricing remain extreme. Short-term support can be found around \$110/ barrel on the perpetual contract, with better support near \$100/barrel.
- **Natural gas prices are moving in tandem with the broader energy complex, trading around \$11.25/MMBtu on both the front-month and even higher on the perpetual contract.** It is more than 40% higher than it was three months ago, a bullish condition for natural gas companies, which have risen to their best level relative to the sector since June 2005. Support on the natural gas perpetual contract can be found around \$10.00, with better support around \$9.00.

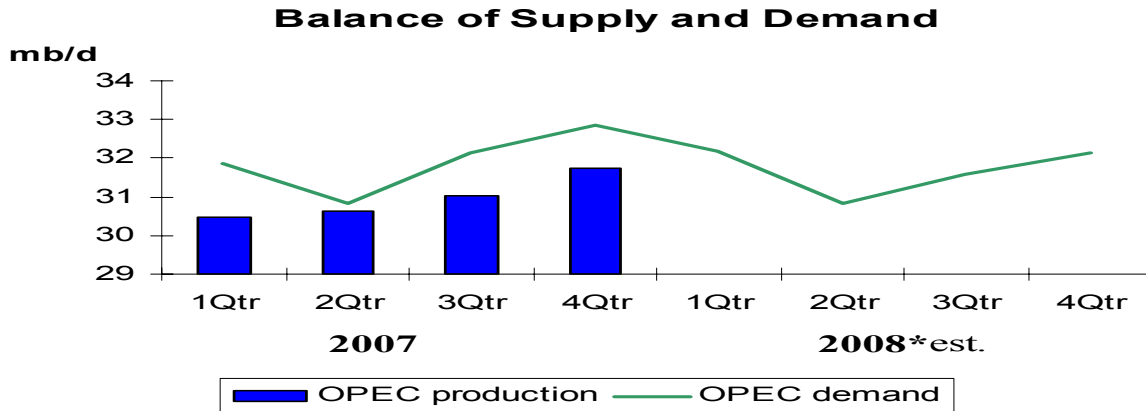
### **“SPOT LIGHT” ON ENERGY SUB GROUPS**

- **E&P continues to make new highs on an absolute basis**, relative to the sector, and relative to the S&P 500, confirmed by its A/D line making new highs. Moreover, earnings revision breadth indicators have turned sharply higher, with the A/D line reaching its highest level in nearly 15 years. But the sub-industry is becoming overvalued, and stretched, by 2.2 S.D. above its mean on a short-term basis, so caution is advised.
- **Coal has regained momentum relative to the sector**, and climbed to a record high on an absolute basis, as coal futures have surged to a new high over \$100/ton. Moreover, the sub-industry has improved to its best level relative to the S&P 500 since March 1981, confirmed by the A/D line reaching its highest point since May 1983. Earnings revision breadth indicators have also turned positive, rising to the best level since August 2003, and the sub-industry is seasonally strong through June. Long-term fundamentals continue to support the sub-industry.
- **Drillers continued to improve**, with price climbing to a record high, confirmed by the sub-industry continuing to trade near its best level since last July relative to the sector, having corrected most of its undervalued condition. Moreover, earnings revision breadth indicators have turned positive.
- **Equipment & Services is finding its footing relative to the sector.**
- **Integrated is also showing signs of stabilization.** The sub-industry remains overbought, on both a long- and short-term basis. Integrated may reassert itself, however, if the economy is indeed in recession.
- **Refiners weakened further**, falling to its lowest level relative to the sector since October 2000, and since May 2005 relative to the S&P 500. Technicals remain in a downtrend, with price falling to its lowest level since June 2005, confirmed by its A/D line weakening to its lowest reading since June 2006, as gasoline margins remain under pressure. Earnings revisions are also being marked lower. But the sub-industry has become oversold on a short-term basis and is extremely undervalued.
- **Storage & Transportation fell to its lowest level** since October 2002, relative to the sector, and since last August relative to the S&P 500. Price is trading at its lowest level in over a year.

### **“CLOSE UP” - THE ENERGY SECTOR**

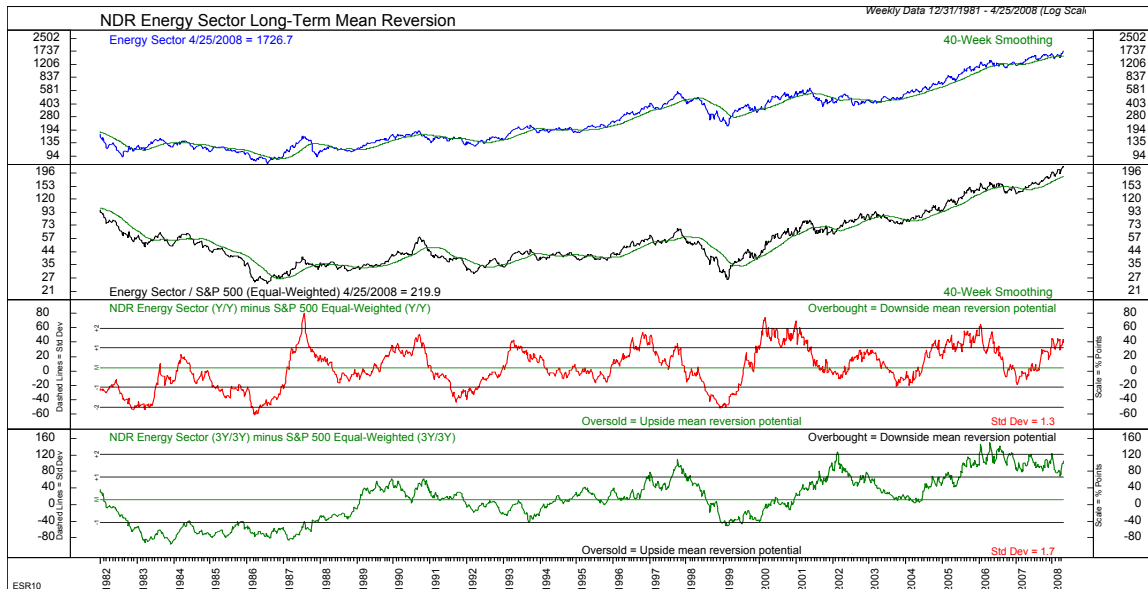
- **The oil markets are at a pivotal point in their sector cycle, indicating “dualism”, or rather challenging directional signals. On one hand the benchmark prices, i.e. WTI, OPEC Reference Basket are reaching record highs indicating a firm market.** The declining U.S. dollar against the Euro has made oil cheaper in other currencies and has also carried prices higher as investors utilize asset portfolio substitutions. This investment strategy involves substituting lower value portfolio assets, for example the U.S. dollar, for a higher value option, in this case, crude oil futures or other investments designed to hedge against the declining dollar. This investment trend impacts short term oil prices by redirecting short term demand for paper-oil contracts.
- **On the other hand, market fundamentals are telling a different story.** An acknowledgement of a possible recession was made by U.S. Fed Chairman, Ben Bernanke recently. If a recession materializes, energy consumption in the U.S., which accounts for over one quarter of world wide oil consumption, will likely come under pressure. A slowdown in U.S. growth would also impact emerging markets which have been responsible for the relative out performance of the energy sector thus far. Latest reports are indicating ample oil supplies showing a continued upward trend during the past 12 weeks, with the latest report of supplies increasing by 7.32 million barrels during the last week in March. Fuel demand declined 1.3% from a year earlier. According to OPEC’s March Monthly Oil Market Report, projections for 2008 growth in non-OPEC supply together with OPEC Natural Gas liquids (NGLs) and non-conventional oil supply will exceed world oil demand growth rates. Consequently, OPEC production would be higher than demand for OPEC crude oil, putting pressure on spot prices. Recent reports of builds in U.S. oil and gasoline stocks should also keep a lid on oil markets.

Figure I (2)



- As a value investor witnessing oil prices at their all time high, we are compelled to consider historical patterns of reversion to the mean. The following Figure II illustrates the energy sector’s long run up to well above its historical mean trend line. The energy sector relative to the S&P 500 line demonstrates the degree of leadership the energy sector has had during the past few years.

Figure II



- Energy shares continue to attract investor interest as inflationary concerns, continued weakness in the U.S. dollar, ongoing geopolitical tensions and a tight supply/demand backdrop, continue to drive oil prices higher. Despite the widespread belief that the U.S. economic slowdown would ultimately lead to falling oil demand, demand trends have held up in the United States and continue to rise globally. From a historical perspective, energy supply sources in the late 70’s were somewhat elastic as elevated oil prices led to the increased use of “cheaper” energy alternatives such as nuclear, natural gas, and coal. However, today these substitute energy supply sources are stretched to full capacity driving natural gas, global steam coal and coking coal prices to all time highs reflecting supply limitations.

(2) OPEC Monthly Market Report-March 2008, Bloomberg’s Robert Tuttle report on Crude Oil, April 3, 2008

- **As we begin the second quarter, we continue to emphasize integrated oil companies within our energy representation, despite our underweight position for the past several quarters.** This strategic shift reflects the disparity in valuations within the sector and relative performance over the past 21 months. The oil service group continues to be the “leverage play” on energy prices, and one of the sector’s highlights in this past quarter as momentum continues to build for accelerated drilling programs. The price of oil per barrel has climbed to newer highs relative to its historic range, and sentiment appears to be very bullish as compared to the overly pessimistic levels experienced earlier in the year. Before upgrading the sector weight, we would like to see a continuation of a supportive Federal Reserve in the next FOMC meeting that ensures the U.S. orchestrates a soft landing. We would also like to see a break in the speculation associated with the enormous spreads we are experiencing between the supply and demand for oil. However, we still recognize the longer term bullish case for energy remains intact sensitized to declining flexibility in production increases, strong demand from emerging markets, and rising costs of finding and developing new reserves (a positive for oil field service and drilling companies).
- **While stock valuations are not excessive under the new assumption of mid \$80’s long term oil, the consensus expectations reflecting higher oil prices over \$125 per barrel appear overly optimistic.** We continue to believe that the assumption of \$85 oil in 2008 is now priced into the markets and appears to be a more reasonable level as world economies begin to slow. The supply issues continue to be the primary determinate. We are now estimating that worldwide oil demand will probably increase by approximately 1.2 to 1.5 million barrels per day and that electrical demand will most likely be at twice that rate of oil equivalents being met by coal, natural gas, wind and solar power.

## FUNDAMENTALS FOR OIL AND GAS

- **In 2007 world oil demand was estimated to reach 85.76mb/d (millions of barrels per day), an increase of 1.4% or 1.19mb/d from the prior year.** The growth was mainly a result of economic growth in non-OECD countries, as well as demand growth in the United States, Latin America, the Middle East, Africa and other Asian countries. Demand in Western Europe and OECD Pacific declined in 2007. In 2008 world oil demand is currently forecast to reach 86.97mb/d, an increase of 1.21 mb/d or 1.4% year over year. The growth mainly expected from non-OECD countries may be partially offset by downward revisions to demand resulting from a weaker global economy than otherwise forecasted.
- **Non-OPEC supply in 2007 was expected to increase by .55mb/d to 49.44mb/d.** The largest supply growth was estimated to be in North America, Africa and FSU with year over year supply increases of .07mb/d, .09 mb/d and .49 mb/d respectively. Supply declines are expected in Western Europe, the Middle East, and parts of Asia. In 2008, non-OPEC supply is expected to increase by .84 mb/d to 50.28mb/d. OPEC natural gas liquids and non-conventional oils are expected to supply 4.93mb/d in 2008, for an increase of .53mb/d year over year. World oil supply is currently estimated by OPEC to average 87.02 mb/d. As compared to estimates for world oil demand for 2008, it suggests the market is adequately supplied. (3)
- **The current administration’s proposal to add to the U.S. Strategic Petroleum Reserve (SPR) was defeated by Congress** this month when voters recognized that achieving the objectives set by the 2004 Energy Policy Act would only aggravate the already high oil prices. (4)
- **In its energy import and production projections, the EIA sites increased biofuel usage, rising CAFÉ standards and higher energy prices as key moderators of energy import growth into the United States.** Corporate Average Fuel Economy (CAFÉ), promotes energy independence and security, increases end product efficiencies, along with increasing production of clean renewable fuels, among many other things. New legislation signed into law on Dec 19<sup>th</sup> 2007 by President Bush aims at increasing current CAFE standards to thirty-five miles per gallon by 2020, an increase of 10 miles per gallon. The new standards would take effect for cars beginning with the 2011 model year.

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(3) “Integrated Oil: First quarter Earnings: Revisions and Preview” Nicole Decker, Bear Stearns, April 10, 2008

(4) Reference Capital Spending and Reserve Replacement trends on pg. 14.

- Additionally, as energy prices continue to rise, the EIA projects U.S. domestic energy production to rise through 2030 (See Charts labeled Figure IV on page 6). These increased efficiencies along with rising prices should ultimately moderate energy import growth into the United States. The analysis further projects a decrease in net import share of U.S. energy consumption from 30% down to 27% in 2030 (Figure IV).

**Figure III** (5)

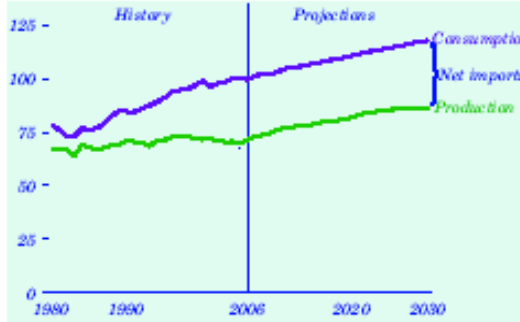


- Global refinery utilization rates which have been on the decline over the past few months can be expected to remain at lower levels due to continued declines in refining margins. Slowing demand and higher energy prices have led rates in this direction.

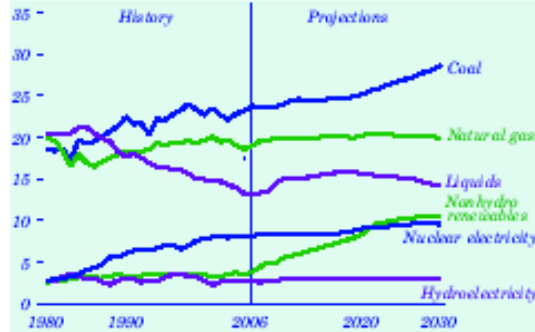
(5). "Integrated Oil: First Quarter Earnings Revisions and Preview" Nicole Decker, Bear Stearns, April 10, 2008

**Figure IV (6-7)**

**Figure 5. Total energy production and consumption, 1980-2030 (quadrillion Btu)**



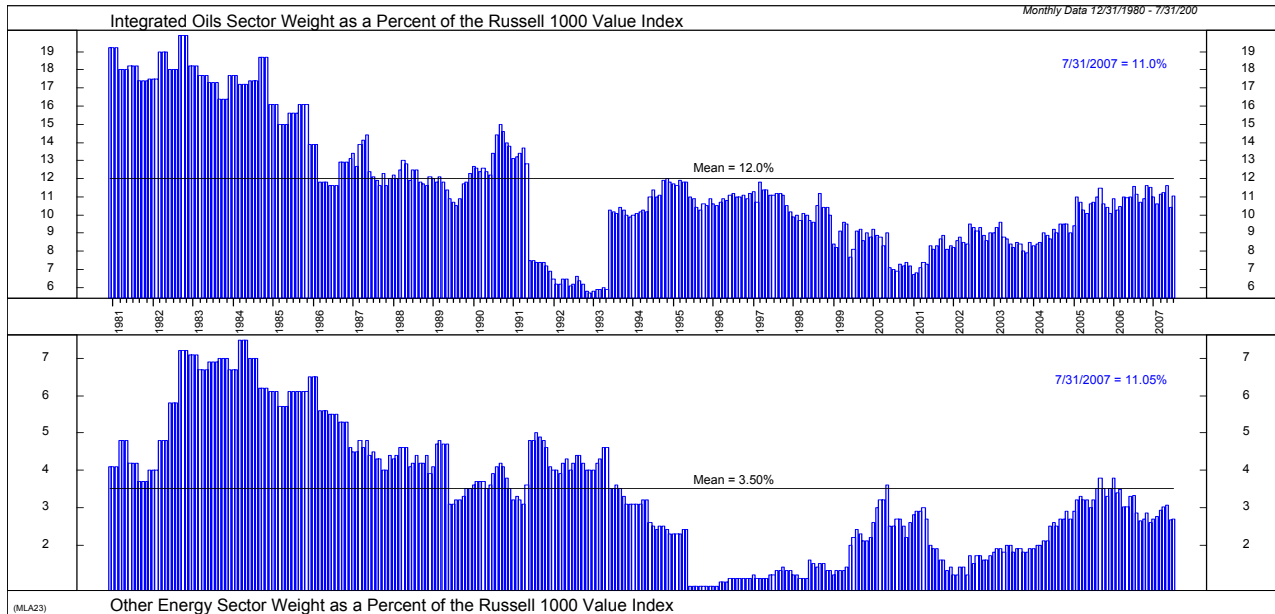
**Figure 6. Energy production by fuel, 1980-2030 (quadrillion Btu)**



- In recent developments, as reported in OPECs April 2008 report, the European Union is moving ahead with plans to increase the amount of ethanol blend currently used in gasoline. Increasing the blend to 10% will raise demand for corn and sugar cane, pushing the prices of these commodities higher. Regulations already in place in the United States to increase the production of ethanol biofuels have been responsible for the rise in commodity prices over the past few years.
- In summary, events supporting higher oil prices included Fed Policy, a weakening U.S. dollar, geopolitical tensions in South America and supply disruptions in West Africa and the North Sea. Supporting lower oil prices were events including, increased U.S. stock builds, declining margins, and possible economic slowdown in the United States.

**Energy as % of Russell 1000 Value: 2<sup>nd</sup> Quarter 2007**

**Figure V**

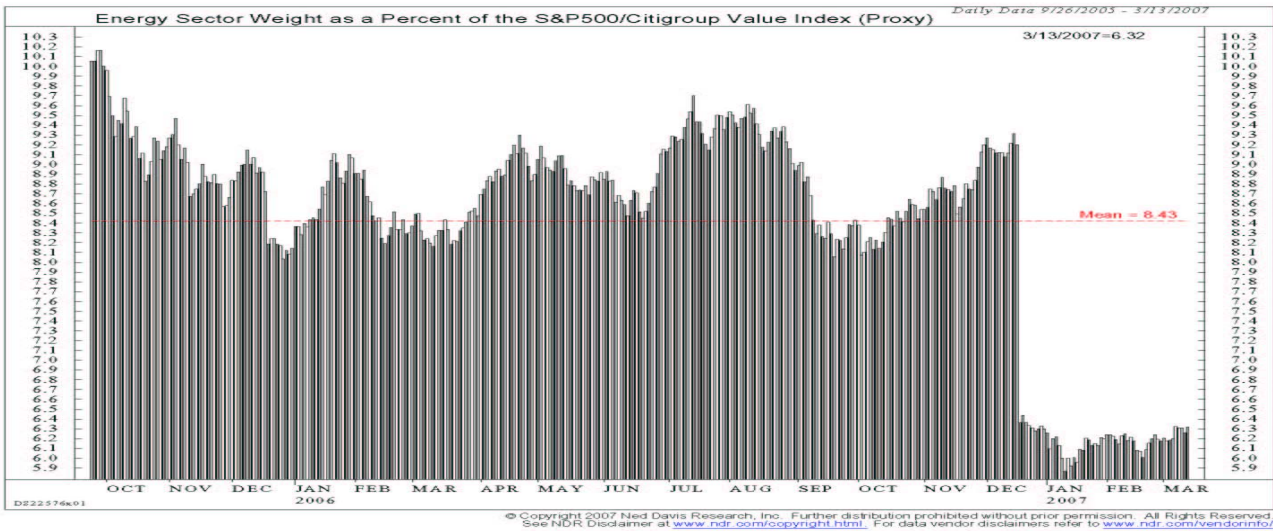


(6) Figure 5. source data: OPEC Monthly Oil Review March 2008

(7) Figure 6. source: Energy Information Administration (EIA) Annual Energy Outlook March 2008

**Energy as % of S&P 500 Value : 2<sup>nd</sup> Quarter 2007**

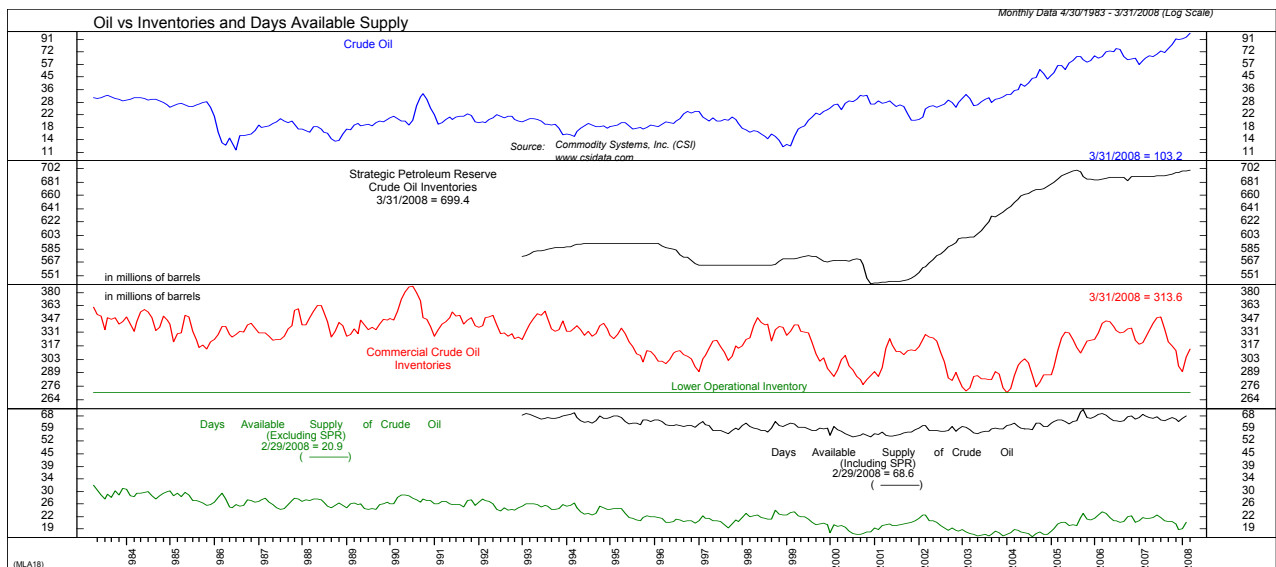
**Figure VI**



Note: The S&P500/Citigroup Value Index revised the Energy sector weighting in December 2006 from 9.2 to 6.3 percent of the total index.

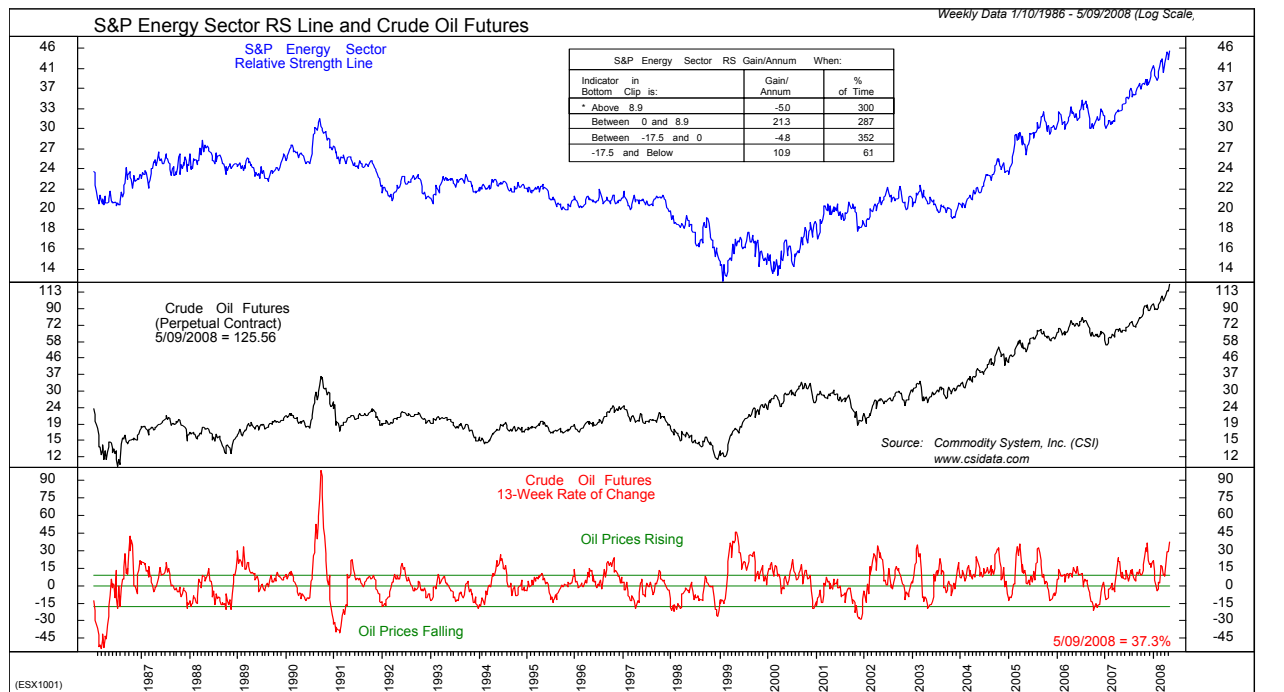
- **Aggregate first quarter earnings are projected to be up some 17% year over year and 2% versus the fourth quarter.** We are expecting that estimate of E&P operating earnings to increase 58% from a year ago, primarily reflecting higher oil prices. We are estimating aggregate oil and gas production at 20.1 million boe /d down 247,000 boe /d, or 1.2% sequentially and down 3.1% year over year. In the Refining and Marketing (R&M), operating earnings are expected to decrease 67% from the first quarter of last year.
- **While the spring season is typically soft for gasoline prices, as we enter the summer driving season one would expect a resumption of the higher prices into the fall.** Despite rising oil prices in April, we don't expect the commodity price for perpetual contracts to maintain price levels above \$125 per barrel for much longer. Most analyst have raised their 2008 oil assumptions for West Texas Intermediate to \$85/bbl primarily based on non-fundamental influences such as the weakened U.S. dollar. With oil prices averaging \$97/bbl in the first quarter, compared to previous estimates of \$85/bbl, we continue to believe that oil share prices are somewhat ahead of themselves and will moderate in the coming months. We have underweighted portfolios in lieu of seasonal forces coupled with supply ramping up in OPEC and non-OPEC sources. Figure VII showing rising inventories could be the precursor to a corrective phase in the oil markets.

**Figure VII**



- **Based on relative and historic valuations parameters, the current high oil and gas prices favor a heavy emphasis on integrated oil companies:** Chevron Texaco Corp., Conoco Phillips, and Exxon Mobil Corporation, remain our top picks. Our underlying assumption continues to focus on the fact that global demand for oil remains strong and continues to be negatively impacted by tight supply within the context of a weakened U.S. dollar. We also had placed a heavier emphasis on a laggard group, the oil equipment and service industry, in our energy sector portfolios in the past several quarters as the majors began expanding their drilling programs at these elevated prices. We would also like to point out that there does not appear to be a material shift yet in consumer purchasing habits in response to escalating gas prices at the pump. Although prices may be near record levels in absolute dollar terms, they are still below these record levels on an inflation adjusted basis. (8)
  
- **As the second quarter of 2008 unfolds, we are maintaining a market underweight in the energy sector by close to 30% in our diversified value portfolios,** reflecting the significant advance in the shares over the past several years as well as valuation characteristics that exceed historical benchmarks. Although the long term bullish case for oil remains intact, we would look for better entry level in the summer of 2008 as valuations come back in line with overall fundamentals before expanding our representation. See Figures V & VI to get a historical perspective on oil/energy as a percentage of the Russell 1000 Value and Standard and Poor's 500 Citigroup Value benchmarks. Remember that there is also a large percentage of energy exposure in the utility sector of the Russell 1000 Value Index . Most of the larger capitalized companies in this sector of the index have significant leverage to unregulated energy businesses. We estimate that the energy exposure of the Russell 1000 Value Index approached 25% in 2007.
  
- **Despite a forecast of a global slow down, energy prices have remained relatively high.** This suggests that energy is no longer trading as a cyclical commodity but more like a “growth” business, where the base case scenario extrapolates the most recent pricing experience rather than the more traditional method of mean reversion. Although it would appear that energy may be susceptible to further earnings revisions, and fluctuations in inventory and spot markets, it is likely that any further increases in the oil price above \$125 a barrel will begin to precipitate a demand response.

**Figure VIII**



(8) Our strategic weight in energy at 9.5% of equity portfolios against 13.3% by the S&P 500 includes 50% of our Archer Daniel Midland investment since the company derives as much as 40% of its operating profits from ethanol. The position is currently classified in the consumer staple sector of the S&P 500 GICS.

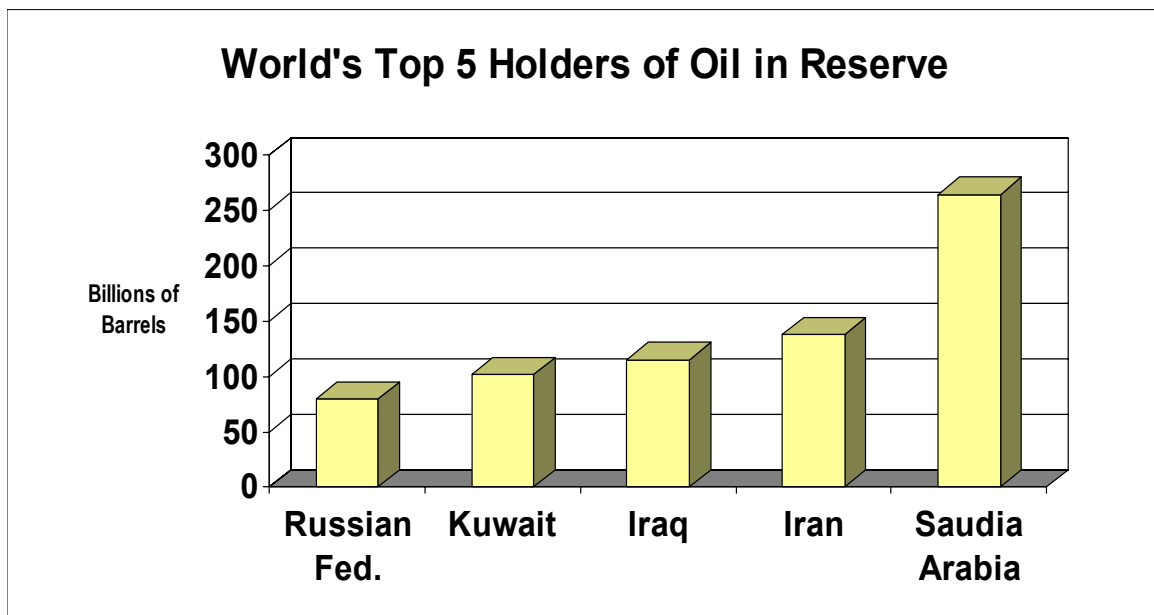


- **The energy sector is entering a seasonally weak period of the year and should persist through the late spring.** Despite rising oil prices in the first quarter, we don't expect that the commodity price for perpetual contracts to maintain price levels in the mid \$120's per barrel for long periods of time. Figure VIII illustrates that the correlation between Crude Oil Futures and the Relative Strength (RS) Line of the industry participants is very high. On closer examination it appears that the share performance has lead the commodity by several months in most instances.

### **"LOOKING BACK" - A PERSPECTIVE ON THE FUTURE**

- **As early as mid 2006, after a significant run up in the share prices of the energy participants, we began to take a more defensive position with regards to energy portfolios and placed a greater emphasis on the low cost producers and select drillers.** We have included two charts FiguresV and VI for a detailed analysis of the industry allocation of the large capitalized value performance benchmarks.
- **Despite market concerns about approaching the top of the current business cycle in a long-term secular upward trend in energy fundamentals, we focused on companies who display a better record at replacing reserves more rapidly than the average player in the exploration and production business.** We do not expect an increasing role of the financial players in the market place as a result of forecasted credit conditions. This new participant has made future predictions of commodity prices even more challenging. Questions still remain such as: will we see any further downside in the price of the commodity and whether the Brent-WTI spread will ever close? Will the larger capitalized integrated oil companies begin to outperform the less capitalized smaller companies in a macro environment that is slowing? Does this new fundamental outlook for global energy warrant multiple revaluations?
- **Prior to the U.S. invasion four years ago, Iraq was pumping 2.6 million barrels a day.** It currently pumps 1.95 million barrels a day, while using only 27 of its 78 known oil fields. The U.S. Energy Information Administration (EIA) states that only about 10 percent of Iraq has been examined for oil. Furthermore, companies were prohibited from investing in Iraq by United Nations sanctions until 2003. Considering that the war's end would likely bring more investment, and the possibilities of implementing new technology, Iraq stands to possibly double its oil production. Stability in Iraq and the end of the war lays the ground work for a significant oil production increase. (Bloomberg Market- Aug. 2007)

**Figure IX** <sup>(9)</sup>

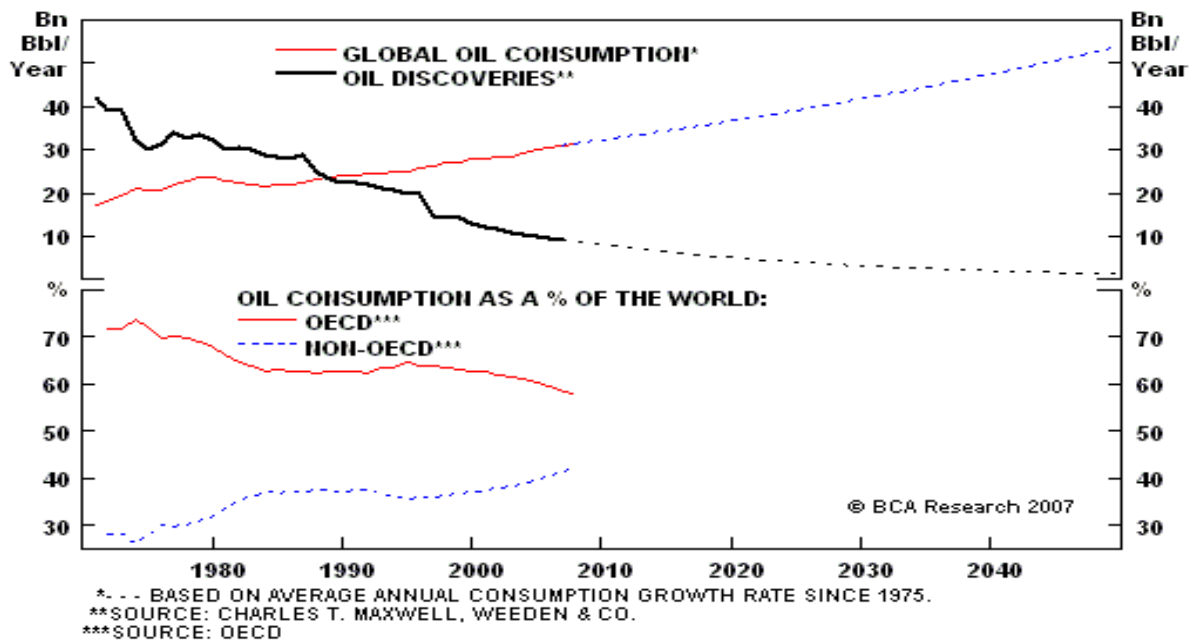


Source: BP Statistical Review of World Energy, 2007

<sup>(9)</sup> Source: Energy Information Administration (EIA) Annual Energy Outlook, March 2008 indicated that Iran dropped behind both Iraq and Kuwait. In estimated oil reserves, according to The CIA World Fact Book, Iran now has an estimated 9.2% of the Global Oil Reserves with Kuwait 9.5% and Iraq 11.1% respectively.

- **Oil consumption started exceeding the rate of oil discovery about 17 years ago, and the disparity has grown each year.** Energy is now being consumed at about twice the discovery rate. The net decline in reserves per well started as early as 1996. EIA shows that the average reserve size per well in the US was down some 35% over the past 5 years and continues this trend today. This geological phenomenon has supported a global rig count that has almost tripled from the late 90's, with capital in U.S. upstream industry exceeding the levels we saw in the late 70's. With the rapid growth and industrialization of China and other Asian countries, this deficit will continue to widen as the demand continues to outstrip supply.
- **Oil prices continue to reflect this secular story and have been rising as the marginal upstream operator maintains adequate rate of return at current levels.** The imbalances between supply and demand ensure that oil participants should remain bullish for some time to come. On a short term basis, the International Energy Agency (IEA) and the Energy Information Administration (EIA) are both expecting a crude oil miss of about one million barrels per day by the end of 2007. As demand drives the costs up, the main beneficiaries of this pending supply-and-demand issue continues to be energy companies. We are increasingly interested in exploring alternative energy solutions. While energy stocks have been on the rise since late summer, their price earnings ratios have not changed significantly and the yields on the shares have been expanding rapidly, leading the S&P 500 in year over year dividend growth. (10)

**Figure X**

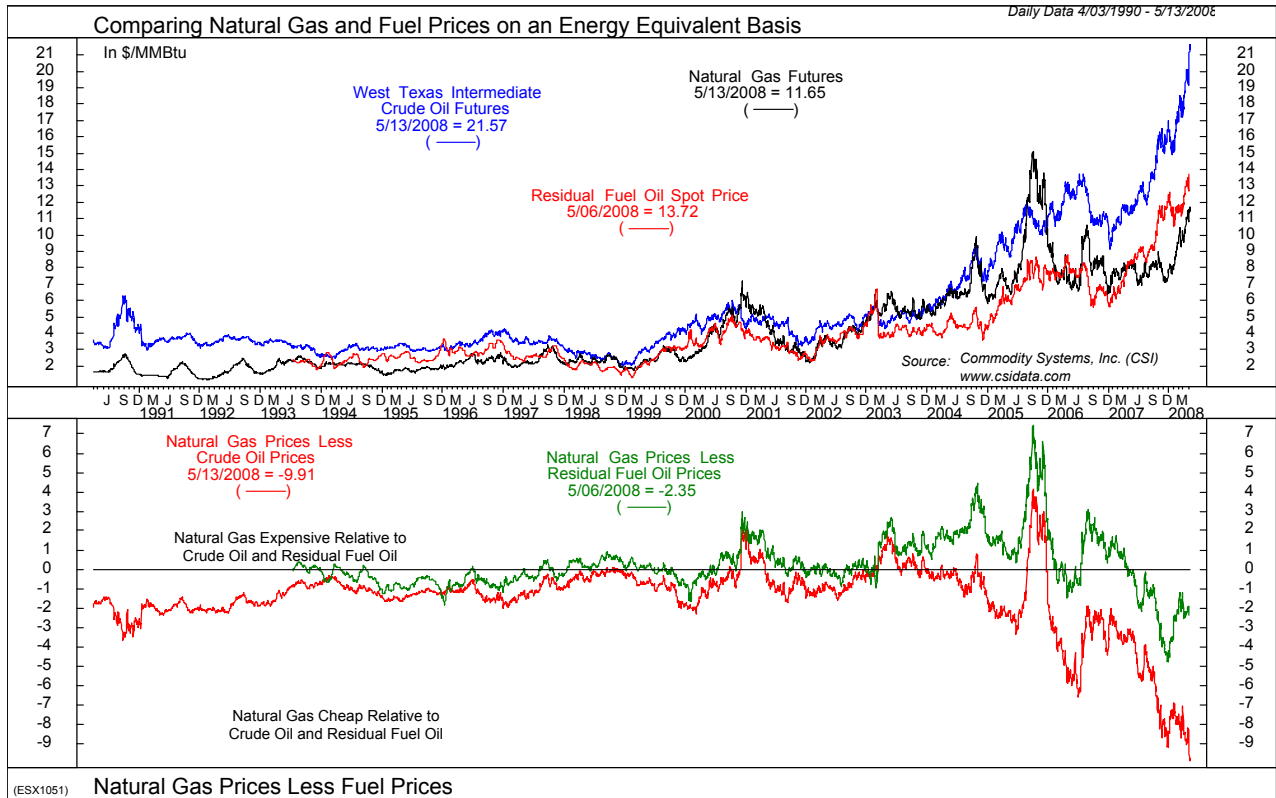


- **We expect natural gas prices to rise in the second quarter to the upper end of a new trading range between \$8.5 and 11.0 /MM Btu more typical of past seasonal patterns.** In early 2008 we were forecasting that gas would rise above the average price of \$6.6 experienced for the past five years. Crude oil, in contrast, has increased significantly from around \$65 per barrel at the beginning of 2008 to the high \$120s per barrel by April of this year. Natural gas hovered around \$6.5 for most of 2007 but broke out with oil in February above \$8.0. We forecasted that the large gap between oil and gas would eventually lead to an increase in demand for U.S. natural gas over time and close the spread between gas and crude oil.

(10) "Twilight in the Desert, The Coming Saudi Oil Shock and the World Economy" by Matthew R. Simmons published by John Wiley & Sons in 2005

- **This steady climb in oil prices has led to a decrease in gasoline imports, but should change over the ensuing months.** U.S. gasoline production currently runs between 9.0 and 9.5 million bbl per day, exceeding the 5-year average of about 8.7 at this time of year. OPEC states that it can increase production by 15% and not yet close to maximum production.

**Figure XI**



- **While we believe the secular uptrend is still in place, the return on capital employed has reached such unprecedented levels that we would expect this to encourage further investment.** Our macro economic forecast for global growth in 2008 is that we will start to see a reduction in overall demand for energy. This phenomenon, coupled with increasing inventories, should compress overall returns and lower absolute oil prices as the year unfolds. Despite the fact that OPEC believes that demand growth will approach normal levels of 1.6% in 2008, the IEA continues to carry a higher forecast than those made in 2007, despite the recent global developments that suggest a weaker macro environment.
- **As spare capacity has grown and inventories have risen to levels at which we would expect to see a price response, we remain somewhat cautious.** Natural gas reserves in the U.S. have had a different experience than oil as reserves continue to grow rapidly increasing by 9.5% in 2007 to 144.6 Tcf. Most of the increase has been due to a turnaround in natural gas revisions, with extensions and discoveries gaining as much as 9.7% to 15.3 Tcf. For the first time in years, according to the John S. Herold, net natural gas reserves purchases were not a major factor in increasing reserves. Production was up 7.9% to 10.6 Tcf, driven by a 20% jump in output by the E&P's. Gas reserves and production of the Intergrades actually fell 2.6% and 3.8% respectively. (11) See Figure XII created by Ned Davis Research showing Natural Gas Storage Levels and Capacity Utilization rates.

(11) John S. Herold: "Global Upstream Performance Review 2007"

Figure XII

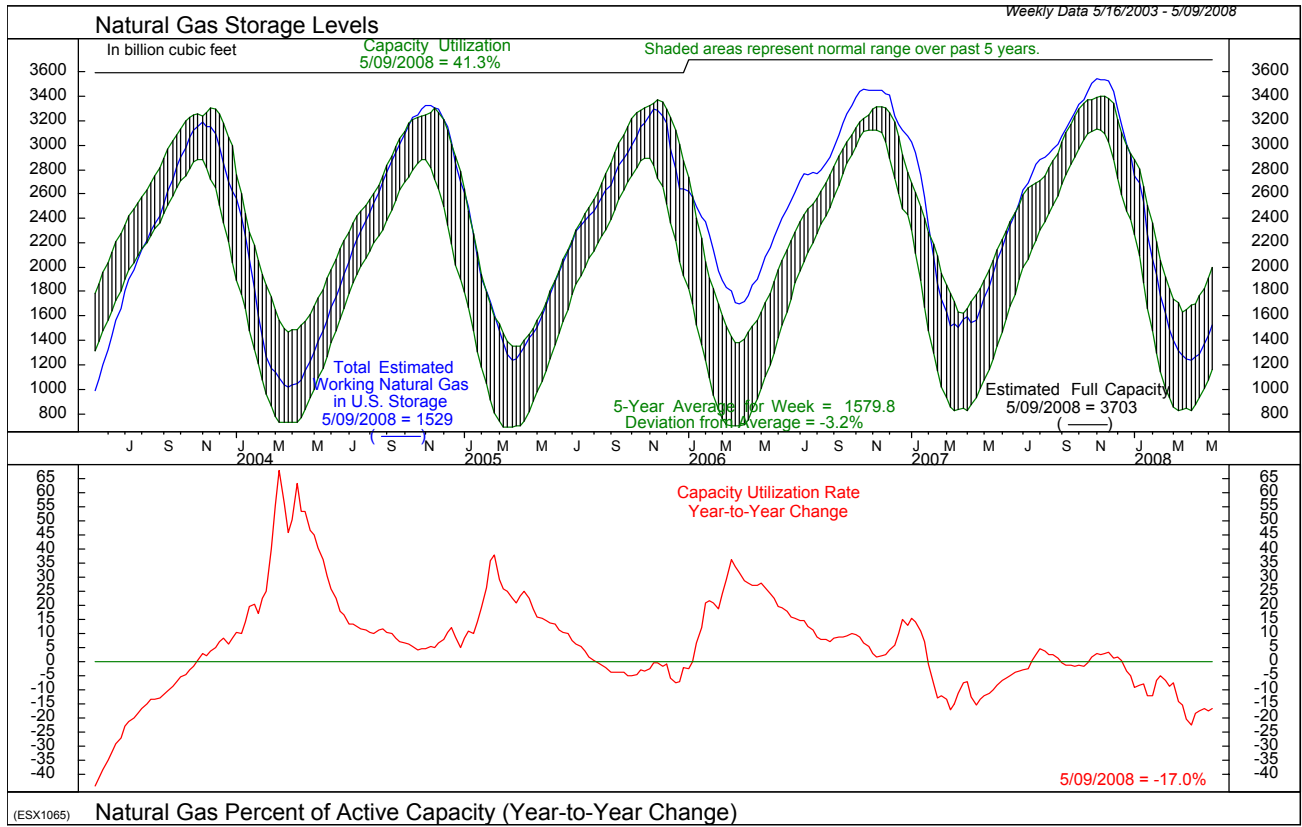
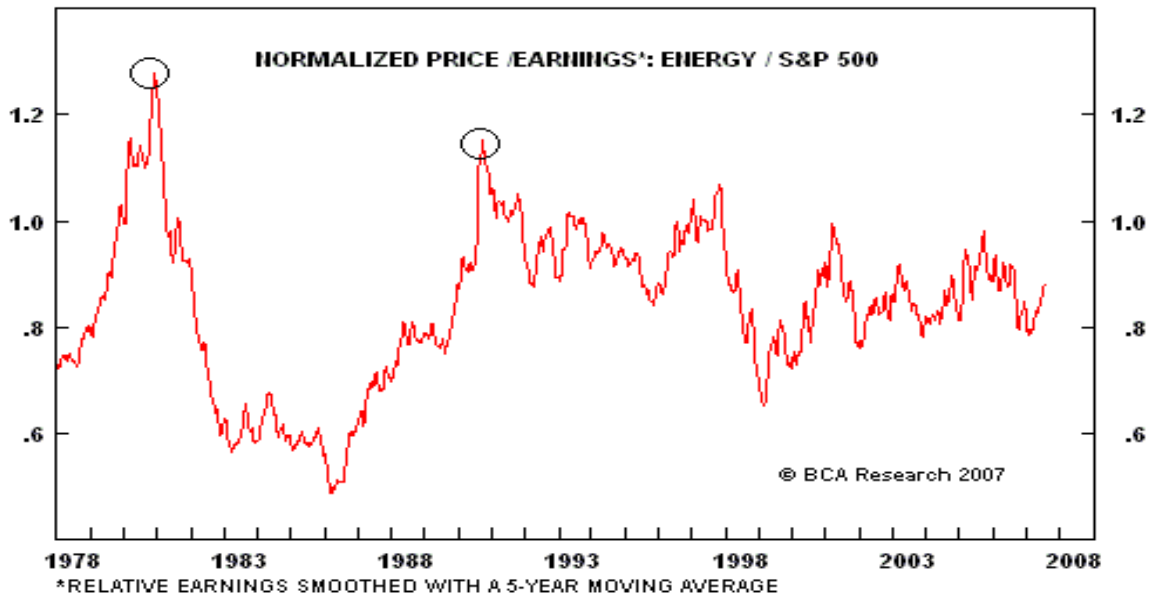


Figure XIII



- **The Oil-Equipment & Services industry has seen significant M&A activity since the beginning of 2006.** We believe that this trend will continue as the capital markets settle down from the recent credit turmoil. This activity could continue for the next several years since many industry experts emphasize that there will be an “acute skilled labor shortage, a high-stakes race for technological leadership, overcapitalization, and undervaluation,” according to Nicole Decker, an oil analyst at Bear Stearns Research, which will contribute to the likelihood of increased M&A. As global demand far exceeds supply, the need for increased exploration is imperative. The oil service industry has reaped large profits from the soaring energy prices, and is now overcapitalized. Consolidation is necessary for the industry to become more efficient and competitive. Cash flows are strong and debts are low, giving the companies the tools necessary to make investments and acquisitions, and to create synergies. Since 2006, Bear Stearns reports that the average premium for target companies one day after the announcements were made were approximately twenty-seven percent higher than the previous days close. Continued M&A activity for oil services companies bolsters the case for further investment, and serves as another catalyst for the underlying industry trend.
- **The United States imports sixty percent of its oil, with over forty percent coming from OPEC.** In terms of the safety of U.S. imports amidst fears of terrorism or war, “only a naval power of the United States” strength could seriously disrupt oil shipments, but the United States is more likely to protect shipping on the high seas than to do anything to endanger it.” (12)
- **With the high oil prices, governments have been supporting alternative sources of energy.** In the U.S. in cooperation with corn growers, ethanol producers have successfully lobbied for corn as a critical alternative; the government decided to heavily subsidize corn-based ethanol. This comes even as other sources, such as wood chips, are potentially a more efficient energy source. The corn industry has grown at alarming rates, with production capacity scheduled to reach about 11.5 billion gallons in 2008. In the summer season of 2007, U.S. farmers have planted 19 percent more corn than the summer season of 2006, and soybean plantings declined 15 percent. However, heavy conversion of corn to ethanol has U.S. domestic corn supplies on pace to be cut in half within only a few years. In 2005, total US ethanol production was 3.9 billion gallons, or 2.9% of the total gasoline pool. Preliminary data for 2006 indicate that ethanol use rose to 5.4 billion gallons. Biodiesel production was 91 million gallons, or 0.21 percent of the U.S. distillate fuel oil market. Ethanol blended into gasoline is projected to account for 4.3 percent of the total gasoline pool by volume in 2007, 7.5% in 2012, and 7.6% in 2030.(13)
- **In the first quarter of this year, corn futures hit \$4.38 a bushel, a ten-year high.** Corn has taken acres away from wheat, rice, and soybeans, driving those prices higher. This also creates a problem for farmers, as feed prices rise, causing price increases for livestock and poultry as well. Ultimately, the rising prices of these futures get passed onto consumers. Many companies, including powerhouse General Mills, have already raised prices. The United States’ 2006 consumption of ethanol was about 6 billion gallons and demand for oil will continue to rise with the economic advancement of India and China.
- **With the long-term future of oil reserves looking bleak, oil prices have an almost endless ceiling for price increases.** This would potentially prompt significant rises in corn future prices as well. Even with grasses, trees, and wheat available to be converted to ethanol, the tax-breaks and government subsidies associated with corn production will keep corn the primary crop for ethanol production. (14)
- **In an interesting new development, the U.S. Securities and Exchange Commission is talking about creating new rules to allow companies to report probable reserves, in addition to the proven reserves.** Currently, companies are not being valued correctly because the probable reserves are unrecognized. This potential upside should benefit Andarko Petroleum Corp., Apache Corp., Chesapeake Energy Corp. Pioneer Natural Resources Co. is also another beneficiary that we do not currently own but shows up as attractive on this basis as well.

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(12) *Smooth Sailing – The World’s Shipping Lanes Are Safe*, by Dennis Blair and Kenneth Lieberthal

(13). Biofuels in the U.S. Transportation Sector.

(14) *Ethanol’s Real Cost*, Foreign Affairs May/June 2007 by Runge & Senauer; and  
*How Biofuels Could Starve the Poor*, *Foreign Affairs*, by C. Ford Runge and Benjamin Senauer

- **Recent evidence of Exxon Mobil and BP reports of lowered investment capital for finding new oil has negatively impacted their relative share prices.** This further confirms investor sensitivity to replacement issues as a key factor in share price performance. Their rationale may be that alternative energy is a better use of capital given their recent experience in finding sizable fields that could reverse their corporate trend. We are now predicting that oil will resume its recent trend hover at \$75 per barrel by year end and approach \$85 a barrel by year end barring no major change in global growth assumptions from current levels.
- 

## **“LOOKING AHEAD”- ENERGY PORTFOLIO STRATEGY**

### U.S. CAPITAL SPENDING

- **U.S. upstream capital spending decreased by 10.4% to \$109.1 billion in 2007 as unproved acquisition spending fell 37%, respectively.** Acquisition spending by Integrates fell to just \$1.9 billion from over \$1.6 billion the previous year in the absence of a major transaction such as ConocoPhillips 2006 purchase of Burlington Resources while U.S. purchases by the E&P companies in the Herold Top 50\* study dipped 5%. The Herold 2008 Global Upstream M&A Review showed total U.S. acquisition transaction volumes rose 14% as significant U.S. assets were acquired by buyers who have traditionally been included in their study.
- **There has been a heightened interest in shale plays and MMS lease sales has kept unproven acquisition spending by the Top 50 at almost twice 2005 levels, while proven acquisition spending was 30% higher in 2005.** Development spending gained another 24% to \$56.0 billion, roughly half of US capital spending as companies continue to take advantage of soaring commodity prices. Exploration spending continued a multiyear advance jumping 18% to nearly \$14 billion, and almost twice the 2005 benchmark.

### RESERVE REPLACEMENT

- **Finding and development costs plunged in the US to \$15.83/boe, primarily due to the dramatic turnaround in reserve revisions.** \* Reserve replacement costs fell an estimated 24% as improvement in Finding and Development costs were offset by an increase of 8.0% in proved acquisition cost to 12.92/boe according to Nicholas D. Cachione at John S. Herold.
- **The finding and development replacement rate surged higher to 170% of production from 88% in 2006 as reserve revisions turned positive at 1.5 billion boe.** The reserve replacement rate increased by about 30%, as the 2008 reserve revisions more than offset a 42% drop in reserve purchases. (15)

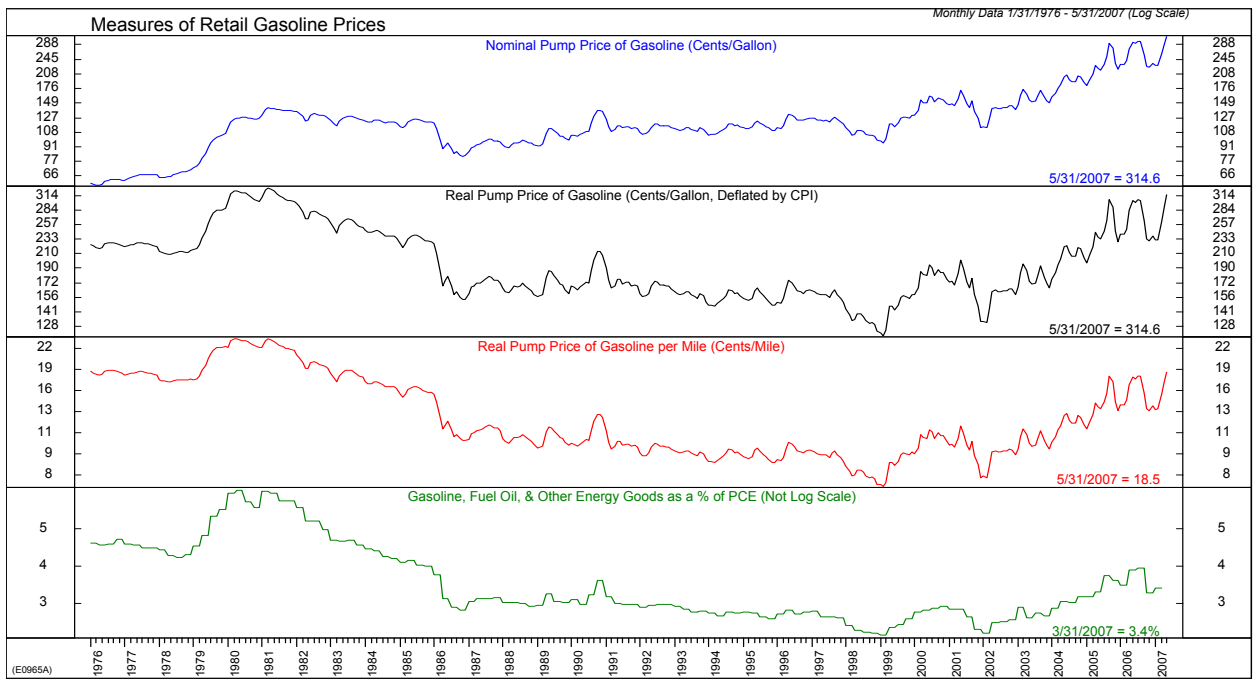
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(15) More details on aggregate reserve information is available upon request. The Herold Top 51 (includes Loews corporation as an extension of the Dominion Resources data set) are the largest SEC reporting U.S. producers by reserve size. Collectively they account for 75% of 2006 U.S. oil and gas reserves and 64% of the U.S oil and gas production as reported by the EIA.

Both oil and gas replacement rates increased modestly to 160% and 297% of production, respectively. But only 78% of oil production was replaced when revisions and acquisitions are excluded. Natural gas replacement rates were much more impressive. Reserve replacement from all sources was 297% of production, 207% via the drill-bit and 152% excluding revisions and acquisitions. (16; 17)

- **Since placing a heavier emphasis on the laggard group, the oil equipment and service industry,** in the fourth quarter, as the majors begin to expand their drilling programs, we still have not seen a material shift in consumer purchasing habits in response to escalating gas prices at the pump. Although prices may be at record levels in absolute dollar terms, they are still at or below these record levels on an inflation adjusted basis.
- **Since the start of the year gas prices have moved in line with oil prices after a large disparity between the price of oil and the price of natural gas last year..** Oil is currently trading above \$125 at per barrel, or 95.0% above last year's levels, and continues advancing to new all time highs consistently all month. Natural gas however is currently trading above \$11 per mcf up ~40% from a year ago levels. An explanation perhaps for the disparity between oil and gas can be found in the fact that gas is more of a domestic commodity than is oil and is affected greatly by weather and storage related issues rather than global demand. A good example of this elastic response was demonstrated in the abnormally cold winter in 2005 followed by an exceptionally warm 2006 in the U.S. which caused natural gas prices to plummet. These factors don't necessarily affect the global community or demand for energy in the emerging markets of the world. (Market Research Insights - *From Russia with Returns*, August 2007)(18)

**Figure XIV**

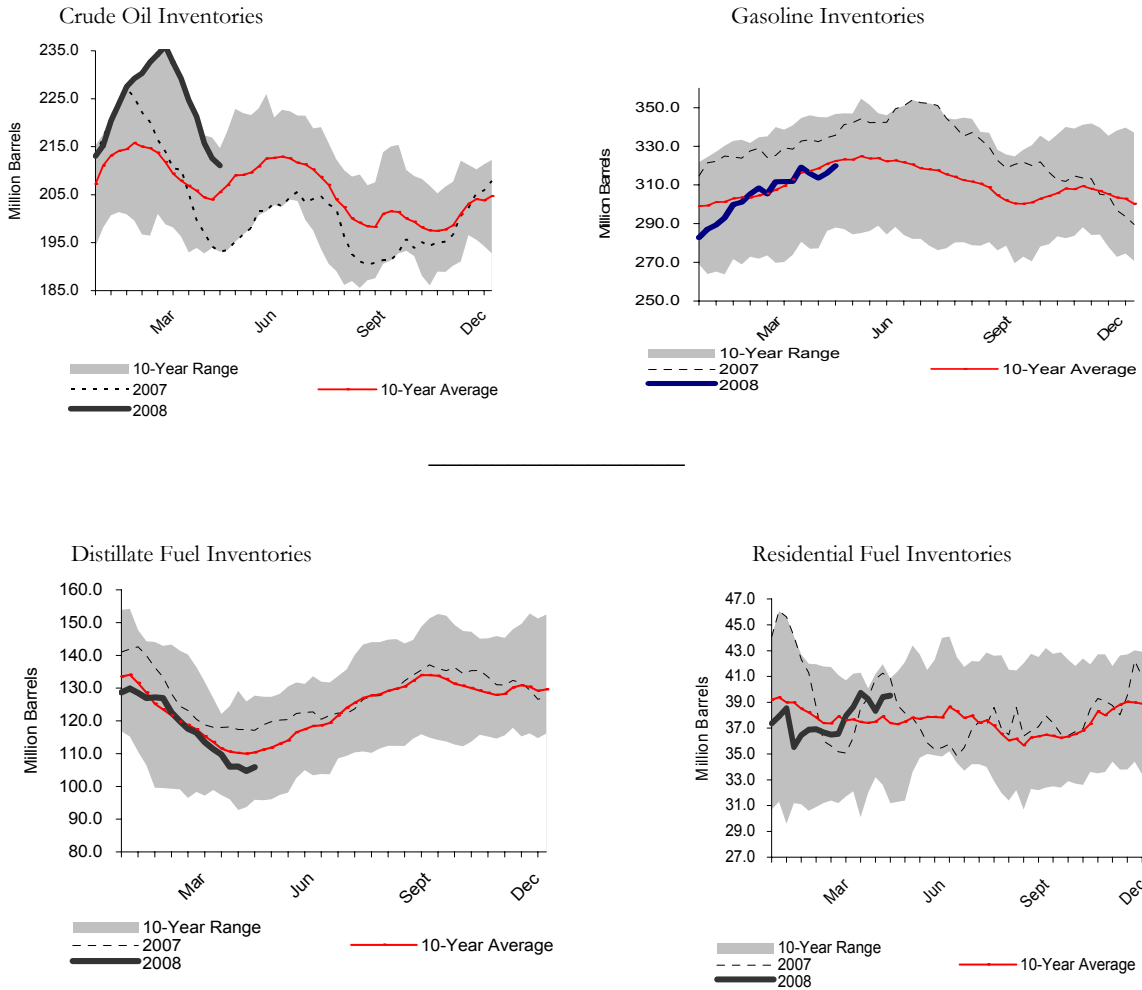


(16) The Herold Top 51 (includes Loews corporation as an extension of the Dominion Resources data set) are the largest SEC reporting U.S. producers by reserve size. Collectively they account for 75% of 2006 U.S. oil and gas reserves and 64% of the U.S. oil and gas production as reported by the EIA according to J.S. Herold.

(17) Petroloco Brasileiro (PBR), may have made another large discovery. The head of Brazil's National Petroleum Agency referred to the "unofficial reports" of another offshore find that could contain as much as 33 billion barrels of oil. If true, this would be the world's third largest field.

(18) "Emerging Markets: Eastern Europe and the Former USSR, *From Russia...with Returns*", published by Altman Investment Management, LLC, August 2007: Available upon request Source:

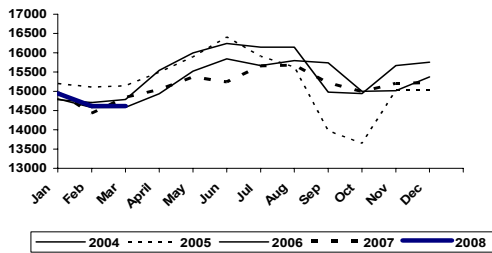
**Figure XV (19)**



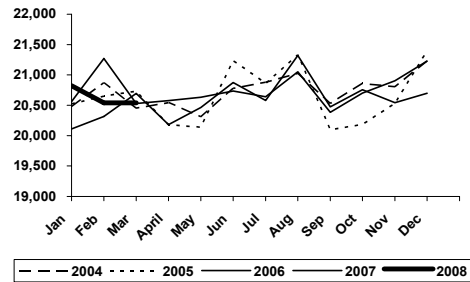
**Figure XVI (20)**

**IMPLIED DEMAND (estimated by month)**

**Crude Oil**



**Total Refined Products**



(19-20) Source: Bear Stearns & Co. Inc. April 30, 2008, U.S Equity Research report entitled "Independent Refiners"

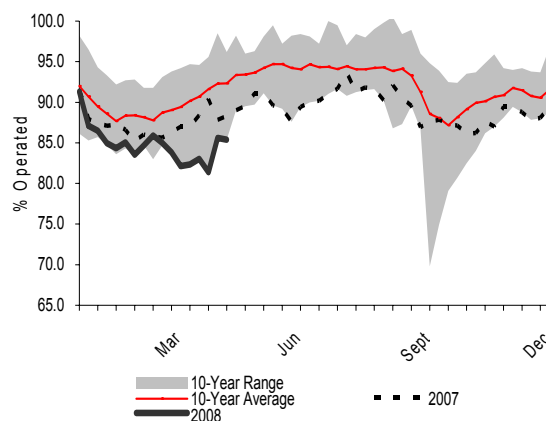


**Figure XVII**

**Implied Demand (YTD)**

(000 b/d)	YTD 4/25/2008	YTD 4/27/2007	Percent Change
Gasoline	9,262	9,330	-0.7%
Distillate	4,461	4,387	1.7%
Jet Fuel	1,616	1,653	-2.2%
Resid	1,004	1,102	-8.9%
Total Products	20,580	20,982	-1.9%
Crude Oil	14,615	15,016	-2.7%

**Refinery Utilization**



Source: Bear Stearns & Co. Inc. April 30, 2008, U.S Equity Research report entitled “Independent Refiners”

**Reserve Analysis of Current Holdings**

- **Although oil supplies on average are meeting current demand, the reserves in the companies we own have improved relative to their peers compared to a year ago.** In 2003 we over weighted the energy sector in our diversified funds reflecting the longer term rising marginal cost of oil and gas. These rising prices have been driven by the decline in reserves size per well in the U.S. which, according to EIA and Bernstein Research, was down to 0.15 MMBoe or 35% over the last five years and continues the downward trend.

**Table II**

Ticker	Name	Energy-BOE Reserves-End Year 2007- Worldwide millions of barrels	Energy-BOE Reserves-End Year 2006 Worldwide millions of barrels	Replacement Ratio	Share Price	Current Shares Outstanding 4/23/08	Crude Oil Futures 4/23/08	Shares*share price/BOE 2007*Crude oil
COP	CONOCOPHILLIPS	10,781	11,592	159%	84.43	1,589,594,000	115.57	1438.74
CVX	CHEVRON CORP	11,213	12,063	11%	92.73	2,076,680,000	115.57	1984.78
XOM	EXXON MOBIL CORP	22,451	22,800	132%	94.26	5,350,027,000	115.57	2595.93
ECA	ENCANA CORP	3,144	3,203	227%	86.87	750,159,000	115.57	2395.54
DVN	DEVON ENERGY CORPORATION	2,497	2,286	194%	118.95	444,390,000	115.57	2446.56
APA	APACHE CORP	2,446	2,313	165%	141.1	332,991,000	115.57	2220.21
CNQ	CANADIAN NATURAL RESOURCES	3,964	3,802	110%	88.01	540,251,000	115.57	1386.24
XTO	XTO ENERGY INC	1,882	1,425	308%	67.88	510,324,000	115.57	2127.77
EOG	EOG RESOURCES INC	1,291	1,134	248%	137.68	247,019,000	115.57	3044.96
APC	ANADARKO PETROLEUM CORP	2,431	3,012	119%	69.74	468,065,000	115.57	1551.63
CHK	CHESAPEAKE ENERGY CORP	1,813	1,493	370%	51.71	534,137,000	115.57	1760.61
MUR	MURPHY OIL CORP	405	388	144%	92.69	189,762,000	115.57	5018.35

Source: Company Releases and Altman Investment Management Research

**Table III**

Ticker		Price to Sales Ratio	Price to Book Ratio	Natural Gas	Crude Oil, Condensate, Natural Gas	% Reserves Developed	Shares*share price/BOE 2006*Crude oil
				Reserves Year End 2007 billions of cubic ft.	Liquids Year End 2007 millions of barrels		
COP	CONOCOPHILLIPS	0.63	1.3	25,438	6,541	72.3%	1338.10
CVX	CHEVRON CORP	0.8	2.3	22,140	4,665	63.9%	1844.93
XOM	EXXON MOBIL CORP	1.12	3.7	68,262	10,380	82.1%	2556.19
ECA	ENCANA CORP	2.65	2.7	13,300	927	54.0%	2351.32
DVN	DEVON ENERGY CORPORATION	4.08	2.1	8,994	998	75.1%	2672.38
APA	APACHE CORP	4.03	2.6	7,872	1,134	68.8%	2347.43
CNQ	CANADIAN NATURAL RESOURCES	3.47	2.7	3,666	3,353	61.4%	1445.31
XTO	XTO ENERGY INC	5.73	3.8	9,441	308	66.1%	2809.89
EOG	EOG RESOURCES INC	7.11	4.2	6,669	179	77.1%	3467.52
APC	ANADARKO PETROLEUM CORP	2.44	1.8	8,504	1,014	66.8%	1252.67
CHK	CHESAPEAKE ENERGY CORP	3.04	2.1	10,137	124	63.8%	2138.74
MUR	MURPHY OIL CORP	0.85	3.1	591	307	53.4%	5235.49

**Notes:**

BOE = Barrels of Oil Equivalent  
 Natural gas equivalent determined using ratio of 6.0 thousand cubic feet of natural gas to 1.0 barrel of oil.  
 BOE reserves include oil sands projects and affiliate companies  
 % developed ratio excludes oil sands except for ECA  
 Replacement ratios exclude oil sands except for XOM and ECA  
 COP BOE includes Venezuelan expropriation impact, replacement ratio excludes this effect  
 XOM replacement ratio and BOE excludes Venezuelan expropriation impact  
 Anadarko replacement ratio excludes divestitures  
 reserves are net of royalties

**Source Data:**

Price to Sales and Price to Book Ratios - Baseline  
 Share Price, Crude Oil Future Price and Shares Outstanding - Bloomberg  
 All other data from year end annual reports

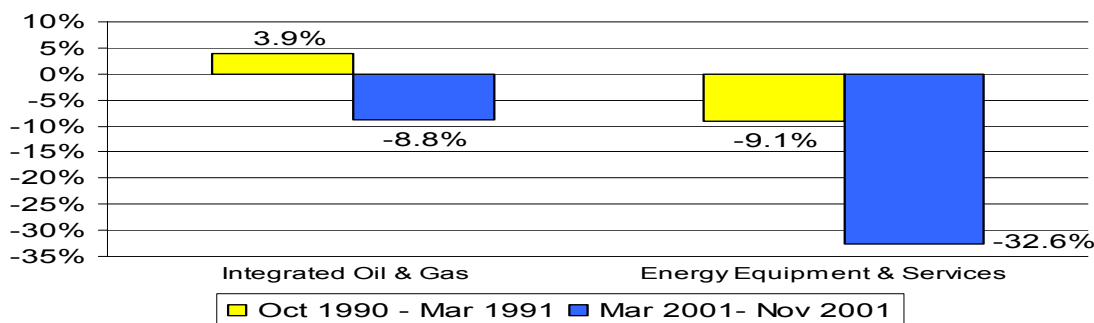
<b>Key</b>	
*	= Proved Reserves only
†	= Crude Oil Futures Price per barrel as of May 23, 2007
BOE	= Barrels of Oil Equivalent
Tcf	= Trillion cubic feet
PR	= Proved Reserves
PDR	= Proved Developed Reserves
TPR	= Total Proved Reserves
MMBbls	= Million Barrels
CO, C, NGLs	= Crude Oil, Condensate, Natural Gas Liquids

Source: Altman Investment Management Research and Corporate Releases.

- **In this environment, we continue to favor the integrated oil companies within the energy sector.** History has shown us that these companies are better positioned for a slowdown in the economy as they tend to be more defensive in nature. As an example, in the past 2 recessions, integrated oils have outperformed oil services by an average of more than 18%. This out performance can be attributed to the relatively diversified nature of business, both upstream and downstream, market capitalization, and healthy dividend yield. We have attached our energy “short list” which includes our ranking system based on quarterly data.

**Figure XVIII**

**Integrated vs. Services Performance During U.S. Recessions**



Source: ML RIC report March 11, 2008

**ENERGY PORTFOLIO VALUATION CHARACTERISTICS**

**RANKING SYSTEM**

**Table IV**

SPX S&P 500

14 2 10.2 15.9 18 32 16.1 17.3 2.5 98,994.5

**ENERGY PORTFOLIO**

Ticker	Company Name	Industry	Month End Price/Sales Rel to SPX	Historical Fwd P/E Rel to Ind	P/E TTM Rel to SPX	5 Yr Hist EPS Gr Rate	Dividend Yield (Indicated Rate)	Price / Cash Flow	ROE	5 Yr Avg ROE	Payout Ratio	P/E (LTM)	P/E 5 Yr Avg	Decile	Price / Book	Market Cap	Total Score											
<b>ENERGY</b>																												
COP	CONOCOPHILLIPS	OIL & GAS-INTEGRATED	0.485	1	0.757	1	0.5	1	26	1	2.2	1	5.5	1	19	1	20.2	1	16	8.2	1	8.4	1	3	1.5	1	134,523.8	11
CVX	CHEVRON	OIL & GAS-INTEGRATED	0.661	1	0.948	1	0.7	1	24	1	2.4	1	7.6	1	23.9	1	26.3	1	28	11.5	1	10.5	1	6	2.6	0	199,672.8	10
XOM	EXXON MOBIL	OIL & GAS-INTEGRATED	0.9	1	1.09	0	0.8	1	29	1	1.5	0	9.7	1	33.1	1	31.1	1	19	12.8	1	13.5	1	8	4.1	0	497,927.0	8
ECA	ENCANA	OIL & GAS-EXPL/PROD	1.984	0	0.968	1	0.9	1	36	1	2	0	7.4	1	22.8	1	21.6	1	22	14.5	1	14.5	1	7	3.1	0	60620.348	8
APA	APACHE	OIL & GAS-EXPL/PROD	3.288	0	0.797	1	1	0	22	1	0.4	0	8.7	1	19.8	1	22.2	1	7	15.9	1	10.7	1	7	2.9	0	44847.227	7
CNQ	CANADIAN NATRL RSC	OIL & GAS-EXPL/PROD	3.163	0	1.42	0	1.2	0	29	1	0.5	0	8.9	1	20.3	1	22.5	1	8	20	0	14.6	1	7	3.4	0	45921.336	5
XTO	XTO ENERGY	OIL & GAS-EXPL/PROD	3.838	0	1.169	0	1.1	0	40	1	0.8	0	10.4	0	24.5	1	28.9	1	11	17.1	1	14.8	1	8	3.6	0	31,568.6	5
CHK	CHESAPEAKE ENERGY	OIL & GAS-EXPL/PROD	2.492	0	1.054	0	1	0	33	1	0.5	0	7.3	1	16.1	1	20.1	1	8	16.2	0	11.5	1	6	2.4	0	26,574.3	5
BHI	BAKER HUGHES	OIL & GAS-EQUIP/SVC	1.723	0	0.807	1	1	0	45	1	0.6	0	12.5	0	25.4	1	22.9	1	11	16.8	1	26.2	0	8	3.8	0	25024.109	5
DVN	DEVON ENERGY	OIL & GAS-EXPL/PROD	3.244	0	0.848	1	1.1	0	19	1	0.6	0	8.7	1	14.9	0	18.7	1	9	17.2	0	10.1	1	6	2.3	0	50393.828	5
MUR	MURPHY OIL	OIL & GAS-INTEGRATED	0.582	1	1.134	0	1	0	26	1	0.8	0	10.6	0	23.6	1	20	1	13	15.9	1	18.2	0	7	3.2	0	17,140.2	5
BTU	PEABODY ENERGY	COAL & CONSUME FUEL	2.285	0	0.632	1	2.5	0	38	1	0.4	0	21	0	16.7	1	19.5	1	15	39.4	0	28.4	0	9	6.4	0	16,566.8	4
EOG	EOG RESOURCES	OIL & GAS-EXPL/PROD	5.652	0	1.307	0	1.9	0	31	1	0.4	0	15	0	17.2	1	25	1	9	29.9	0	16.2	1	8	4.6	0	32231.037	4
SLB	SCHLUMBERGER	OIL & GAS-EQUIP/SVC	3.655	0	1.06	0	1.5	0	57	1	0.8	0	16.8	0	37.8	1	27.9	1	18	23.5	1	31	0	9	7.6	0	120,429.8	4
APC	ANADARKO PETROLEUM	OIL & GAS-EXPL/PROD	1.885	0	1.019	0	1.2	0	17	1	0.5	0	7	1	10.1	0	20.8	0	11	19.7	0	10.1	1	4	1.9	0	31,154.4	3
<b>INDUSTRIALS</b>																												
ESLR	EVERGREEN SOLAR	ELECTRICAL COMPONENTS	9.658	0	NM	0	NM	0	1	0	0	0	0	0	1	0	0	0	0	0	0	0	0	5	2.2	0	1,039.3	2
AKNS	AKEENA SOLAR	ELECTRICAL COMPONENTS	4.149	0	NM	0	NM	0	1	0	0	0	0	0	1	0	0	0	0	0	0	0	0	8	5.1	0	182.6	2
<b>INFORMATION TECH</b>																												
AMAT	APPLIED MATERIALS	SEMICONDUCTOR EQUIPMENT	1.936	0	0.981	1	0.9	1	36	1	1.3	0	12.9	0	23.1	1	18	1	20	15.2	1	39.3	0	7	3.4	0	25,258.4	6
<b>MATERIALS</b>																												
ATI	ALLEGHENY TECH	STEEL	0.937	1	0.889	1	0.6	1	82	1	1	0	9	1	35.9	1	38.9	1	9	10.4	1	15.4	1	7	3	0	6,948.3	9
AUY	YAMANA GOLD	GOLD	7.868	0	0.805	1	1.3	0	1	0.3	0	18.4	0	25.3	1	1	7	21	1	129.7	0	6	2.5	0	8,035.3	5		
<b>VARIOUS OTHER HLDGS</b>																												
IGF	ISHARES GOLDMAN NAT	EXCHNGE TRADED FUND	NM	0	NM	0	1	0	1	0.8	0	0	0	1	0	12	15.4	0	0	0	0	0	6	2.8	0	2,426.6	2	

Source: Thomson Financial & Altman Investment Management Research

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