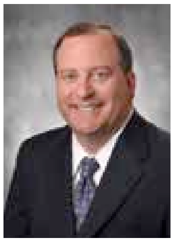
Volatile markets keep focus on quality, long-term approach



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THE ONGOING STRENGTH OF THE U.S. DOLLAR and the slowing economic growth rate in China continue to hold global oil prices in a range of about $35 to $60 per barrel. China is the world's largest importer of crude oil at 7.2 million barrels per day (bpd), compared with the U.S. at 7.1 million bpd. Concerns about the pace of economic growth overall in emerging markets, continued but slowing supply growth, increases in global inventories and the possibility of increasing volumes of Iranian crude oil coming to market have been factors in persistently lower prices.

Short-term volatility

The world produces about 95 million bpd of crude oil. About 90% of the increase in total output in recent years was from Brazil, Canada, Saudi Arabia, the United Arab Emirates and the U.S., where total output has reached 9-10 million bpd. That includes 3-4 million bpd from shale. By comparison, the U.S. consumes about 20 million bpd.

We think "headline risk"—the response from investors to news stories and world events – will remain a key factor in the coming months. For example, it's likely that oil storage issues will become an issue in the news, although not in reality, as happened early in 2015. While we reached all-time high storage levels in spring 2015 in terms of barrels stored, news stories about a potential capacity shortfall did not reflect additional storage that had been built since the prior supply glut.

An agreement on nuclear facilities completed with Iran in 2015 prompted many analysts to suggest that Iran may be allowed to export oil to western countries, adding to oil supply/demand problems. However, we believe the world will need Iran's oil in 2016 just to maintain a healthy balance in supply/demand and to prevent a sharp price spike. Iran's energy infrastructure has lacked western influence for more than 35 years. We think Iran will require significant investment before it can export at the levels some have suggested. We estimate Iran will reach exports of 500,000 bpd by the latter-half of 2016.

We have said since 2014 that we believe the Organization of Petroleum Exporting Countries (OPEC) is not aligned in its view of reducing production to boost prices. Several countries in the Gulf Cooperation Council (GCC)—Saudi Arabia, the United Arab Emirates, Qatar and Kuwait—are OPEC members that have spare capacity and the lowest production costs. These countries are key OPEC decision-makers and do not want to give up market share by any change in production. This is especially true for Saudi Arabia, which has shown a continued willingness to absorb lower oil prices in order to pressure U.S. shale producers as well as Iran and Russia.

We think current supply/demand factors as well as these headline risks will hold down oil prices in the short term and global supply and demand will come into balance by mid-2016. It is important to remember that even outside of demand growth from growing economies, low oil prices have historically driven greater demand and the past year has been no different. Demand has grown in 2015 by about 1.8 million bpd.

Portfolio focus

The Fund seeks to provide capital growth and appreciation by investing in the equity and debt securities of companies around the world that are within the energy sector or that develop products and services to enhance energy efficiency.

We focus on companies that are the lowest-cost providers in their industries and have the ability to increase margins and returns even when commodity prices are flat. Across the energy industry, any further drop in prices will continue to put pressure on companies with weak balance sheets. We believe the companies that can survive at current oil prices therefore will thrive at higher prices.

A current theme for the Fund centers on upstream, onshore U.S. companies. We typically do not invest in companies that, in our view, do not hold either the best or second-best acreage in a given shale area.

The Fund typically seeks companies that we believe can do well over a two- to three-year time horizon, based on a fundamental analysis of those companies. We do not pursue short-term swings in the price of underlying commodities.

Five Key Factors In Energy Markets Now

KEEP IN MIND SOME KEY IDEAS WHEN CONSIDERING THE FUTURE DIRECTION OF OIL AND ENERGY DEMAND:

1. Prices Fall, Demand Rises, Supply Gaps

The last four major oil cycles have one thing in common: Falling prices, increasing demand, and pressure on supply. Growing demand and declining supply then tend to push prices higher. We estimate the world is oversupplied by 1.5-2.0% on total consumption of 95 million bpd and estimate 2015 demand growth at more than 1.5 million bpd, largely driven by lower prices. We think the year-over-year increase in global supply now will start to diminish as Organization of Petroleum Exporting Countries (OPEC) and U.S. shale output are slowing.

2. OPEC Adds Supply

While markets were looking for a cut in production to help support prices, OPEC in 2015 increased its output by about 1 million bpd. It could could add another 500,000 bpd from Iran in the first half od 2016 as sanctions against that country are lifted. That increase in supply could resolve the expected gap because of steadily increasing demand and prevent price spikes. Depending on the demand environment, we think the supply/demand imbalance will be corrected by the second half of 2016. Looking to 2017-2018, we think capital spending cuts across the industry will continue to affect supply and oil prices will move steadily higher as demand grows.

3. U.S. Shale Poised To Recover

Shale oil producers have significantly cut marginal costs. While all U.S. shale offers opportunities, much of our focus is on the Permian Basin as the place we think production growth is most likely to continue. The companies in the Permian still are in the early stages of improving efficiency and productivity. They are reducing costs faster than in the other, more mature shale areas. We continue to believe that the huge land area of the Permian versus other shale plays and its multilayer potential make it a massive opportunity for selected companies active there. Given the slowdown in U.S. shale output on the back of lower oil prices, we do think it will be difficult to get U.S. shale growth again by mid-year 2016. The drop in oil prices caused many U.S. exploration & production companies to become more efficient and more productive per well, cutting costs and focusing on the best shale areas and their best wells. We think that will continue in the near term, with the rig count perhaps moving a bit lower. But we think the wheels are in motion to correct the supply/demand imbalance, as noted above, which will mean a healthier environment for shale producers.

4. Oil Majors, MLPs Face Challenges

We believe the business model for oil majors—also known as integrated oil companies—is challenged now. Prior to the OPEC meeting in late 2014, integrated companies were cutting costs and lowering capital expenditures (cap-ex) because it was difficult to be profitable with oil at $100 per barrel. That raises questions about their profit potential now since oil is at much lower prices. In addition, oil majors historically have been viewed as a defensive investment; they have tended to do relatively better when the energy sector falls and relatively worse when it rises. Given our outlook, we do not wish to be defensive now— as most passive, index-based funds are at this point because of the oil majors weighting in the benchmark index. We also think Master Limited Partnerships (MLPs) as a group have challenges now from valuations, slowing U.S. oil production and flattening growth. We do have exposure to fee-based MLPs, mainly in our preferred Permian Basin, but do not invest now in upstream MLPs or service/driller MLPs.

5. Bias To High Quality

The Fund is focused now on what we believe are the best companies with the best balance sheets, best oil acreage, low-cost production and ability to grow even in a low-price environment. We're seeking names that can survive and even thrive in a low-price environment. We think the valuations of refiners still look attractive and believe U.S. refiners will have a low-cost advantage relative to the global refining market for some time to come. We believe that, when you're in a commodity, you must understand the fundamentals and filter out the short-term volatility and noise.

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