

# Energy and investing

Portfolio managers offer their thoughts on the cause of lower energy prices; the winners and losers; and how they have portfolios positioned.

## Executive Summary

- Politics may have played a key role in the plunge of prices; however, basic rules of supply and demand likely will bring prices back up.
- Consumers are obvious beneficiaries of lower prices while producers are being squeezed in the short term. The latter already is being reflected in earnings estimates while the former is not.
- There remain areas where managers see investing opportunities created in the current environment.



**Energy** – one of the primary components of inflation as well as something that virtually every person and every company uses, directly or indirectly – has been a hot topic since late November when the Organization of the Petroleum Exporting Countries (OPEC) decided not to cut production and prices fell to levels not seen in years. Eagle's portfolio managers dedicated a good bit of time during their annual roundtable discussion on the topic. Their conversation is below; however, some of the highlights include:

- Politics may have played a key role in the plunge of prices; however, basic rules of supply and demand likely will bring prices back up;
- Consumers are obvious beneficiaries of lower prices while producers are being squeezed in the short term. The latter already is being reflected in earnings estimates while the former is not; and
- There remain areas where managers see investing opportunities created in the current environment.

**Cooper Abbott:** What do you think caused the current price scenario? Is it supply? Is it demand? Something else?

**Eric Mintz:** I think what OPEC (Organization of the Petroleum Exporting Countries) signaled at its late-November meeting was: “We do not care. The price is going to go where it goes. And there won’t be an emergency meeting in February. We will meet again in June and talk about it then.”

So the spotlight goes onto North American production, which now is at 9 million barrels a day – up from 6 million barrels a day three years ago – and continuing to grow.

**Ed Cowart:** The more I think about this, the more I believe that there is more of a political aspect of what the Saudis – who really run the OPEC show – are doing. I believe they are trying to put pressure on Iran, which has sponsored Shiite rebels in Yemen and Iraq. They are trying to put pressure on Russia, possibly because the Saudis don’t like what Russia is in Syria and possibly because they want Russia to join OPEC. The more I think about what is happening with Saudi Arabia, which is really the only member

of OPEC that matters, the more I think this cannot be an economically driven decision.

I think there is a lot more to what Saudi Arabia is doing rather than simply trying to eliminate a marginal oil producer in west Texas. And they are not going to kill off shale. We know where the shale is and it will still be there in six months or a year or five years.

**Mintz:** I believe that weaker-than-expected demand has played a role and there’s not a lot of transparency about demand in places such as China. It is clearly more of a supply issue specifically in North America.

**Cowart:** As Eric says, nobody really knows what is happening in China but the data we have suggests that they continue to import at a record level of oil imports.

**Todd McCallister:** When I look at the Saudi Arabian production numbers, it doesn’t seem like they have anywhere near the spare capacity they claim. Satellite photos appear to show the Saudis drilling

like crazy, which isn't what one would expect from a country that says it has an abundance of spare capacity.

**Cowart:** I do not think they do. Of course, nobody really knows but they have put billions and billions of dollars into their production over the last 10 years. They are essentially trying to run up the down escalator.

There is a natural tendency of demand for oil to grow. People in developing nations want to move up from a bicycle to a motorcycle and then to an automobile. At the same time, there is a natural decrease in supply. There is a finite supply of crude oil. And the nature of production is that if a driller brings up 1,000 barrels a day this year, it will be lucky to produce 900 barrels a day next year and probably less than 800 barrels daily the year after that.

**Abbott:** So, what does all this mean for oil prices?

**Cowart:** This much is abundantly clear to me: Prices have overshot to the downside at least on a cost basis. But how long could prices stay here – or if they could go even lower for a period – is an open and legitimate question.

The reality is that \$45- or \$50-per-barrel prices are below the production cost here in North America. That's still fine for Saudi Arabia, which probably has a "lifting cost" of about \$20 per barrel, but current prices are certainly taking a bite of their profits and certainly hurting higher-cost producers. I have to believe that by the time the June OPEC meeting comes around, a lot of

countries that previously had said they're not interested in cutting production will have changed their tune: "Please, please let us cut production so we can get oil back to a level that we can at least cover our national operating budgets."

**Mintz:** The solution to low prices is low prices.

**Cowart:** Exactly. I believe we will see supply and demand come together in a world that has not been overly supplied. The question will be how much they would have to cut to make the reduction worthwhile.

---

“ *The solution to low prices is low prices.* ”

– Eric Mintz, CFA

---

**Stacey Nutt:** Hasn't there been some resistance to this based on the notion that some major oil producers, such as Russia and Venezuela, would cheat anyway even if they were to agree to control volumes?

**Cowart:** They probably would if they could. But they cannot. Russian production is capped out right now at

around 10 million barrels a day. A big difference between now and 1986 – the last time Saudi Arabia punished the Western producers – is that in 1986, the world was using 59 million barrels of oil a day and there was 14 million gallons per day of spare capacity.

Today, we are using about 93 million gallons per day and there is maybe 2 million gallons of spare capacity.

**Nutt:** I worry about oil prices because they're so hard to predict. There was some discussion here about whether shale would really have an impact on oil prices and now oil's half of what it was then. I don't know if oil demand will increase when we have

increasing numbers of alternative energy sources. Nearly one-quarter of Germany's energy comes from alternative sources.

**Cowart:** Yes, and the Germans pay about five times as much for electricity as we do here in the United States.

Alternative energy sources on a worldwide basis are less than 1 percent of what's being consumed. And the International Energy Agency projects that 25 years from now, they will be 2 percent unless countries want to subsidize those technologies in a massive way.

In terms of the amount of energy packed into a small area, there is nothing like a gallon of gasoline.

**Mintz:** Part of my outlook is based on the idea that oil is used for transportation. Increased fuel efficiencies in the fleets of the developed world may represent a headwind for demand. However, the price of gasoline has little influence on nuclear, solar and wind power, all of which are for power generation.

**Cowart:** One other consideration in all this is that U.S. oil found in shale is not like oil found elsewhere. It's fairly limited geographically and in quantity. We have added 3 million barrels a day of shale oil in the last five years but I don't believe we go from here to six or nine or 12 million gallons daily. I believe we are hitting the peak efficiency in terms of extracting oil from those rocks

*“The benefits (of lower prices) are spread wide and thin whereas the costs of lower prices are very visible and very acute.”*

– Ed Cowart

**James Camp:** I remain somewhat stunned that how something so important to the global economy can collapse so quickly and seemingly unbeknownst to those in the business of discussing such issues. I believe lower oil prices are a generally good thing but the speed at which this moved is disturbing because we haven't yet seen all of the damage – at least to the financial markets – that this is going to create. And what is this telling us?

**Abbott:** Let's discuss what current prices mean. Clearly, this hurts producers but it potentially has

positive impacts for consumers. What also does it mean for the markets and their exposure to the commodity as well as the global economy, both in the short and longer terms?

**McCallister:** It is a mixed bag because it definitely helps consumers but about 35 percent of overall U.S. capital spending is energy-related, which was

probably above historical trends. Quite a few companies missed earnings estimates in the last quarter because they had revenues tied directly or indirectly to the energy sector. Overall gross domestic product (GDP) growth could be a bit slower than it has been.

**Cowart:** I believe that, on balance, lower oil prices are a positive for economic growth. The issue is that the benefits are spread wide and thin whereas the costs of lower prices are very visible and very acute.

The benefits are seen by everyone who drives a car and sees that gasoline prices are half what they were last summer. There are tens of millions of drivers

so that is a very broad benefit. On the other hand, the last guy hired in Texas to drive an oil truck and was set to make \$80,000 annually is now out of a job. That is a very acute negative for that person and you can multiply that by many thousands of people.

**Bert Boksen:** Lower oil prices have, by some estimates, put about \$60 monthly in consumers' wallets. That, in turn, benefits companies such as convenience stores and other companies – think restaurants and recreational vehicle (RV) manufacturers – tied to increased travel.

**Cowart:** Lower prices already are being reflected in earnings estimates. The mid-December cumulative estimate for S&P 500 companies' earnings was about \$135. Now, it's more like \$125 primarily because everyone has cut their energy earnings estimates right at the beginning of the year.

(There may be a couple dollars factored in there for a stronger U.S. dollar.) But what analysts haven't done yet is factor in the benefits of lower energy costs. As an example, airlines' costs are going down but many have said they won't lower fares, which should push up gross margins.

That sets up what could be a really interesting dynamic for 2015. Wall Street analysts usually start new years with optimistic earnings estimates that usually creep down as the calendar advances. This year, we may start with low estimates that actually go up over the course of the year as benefits of lower oil prices become more clear.

**Camp:** The whole commodity space, not just oil, is down significantly. We talk more about oil but the global commodity market is slipping. I would suggest that is due to – among other things – fears about the Eurozone economy. There has been a tremendous amount of capital spent in the energy sector, which had been a bright spot for labor markets due to job creation as well as wage growth. That part of the U.S. economic-recovery story is in doubt so it really is unclear how all this will ripple through the markets and the overall economy.

**Abbott:** Stacey, you and your team have so many different strategies, it is almost tough to know where to start, but, give it a go, if you would.

**Nutt:** We have tried to stay in the middle of the boat and not guess about what is really unknowable. I believe it's a good time to eke out gains on individual stocks, slowly

but surely, and not get too overly concerned about biotech in one month or oil another month. There's always going to be a headline that creates volatility and the only thing the headline volatility will do is get you in trouble if you pay too much attention to it.

**Abbott:** Some of this is speculation about what might happen. Are we seeing reactions already beyond lower prices at the pump?

**Mintz:** What has really jumped out to me is how dramatically consumers' behavior already has adjusted to lower prices. Gasoline demand – a four-week number reported weekly – is up 8 percent. And today, General Motors reported that its SUV sales were up 109 percent year-over-year for January.

---

“ (We) usually start new years with optimistic earnings estimates that usually creep down as the calendar advances. This year, we may start with low estimates that go up. ”

– Ed Cowart

---

The other reaction has been in the oil field, where we see the rig count dropping about 100 rigs per week. I believe we could see a 50 percent correction in the rig count, which was about 1,600 in September. We are now at 1,200 and probably moving toward 800, which sets prices up for a V-shaped recovery.

**Cowart:** The United States never has used 9 million barrels a day of gasoline in the winter time but that is exactly what is going on. We have increased U.S. gasoline demand – on a year-over-year basis – by about 800,000 barrels a day. U.S. gasoline is the biggest single use of oil in the world.

The International Energy Agency projects that in 2015, world demand is going to be 1 million barrels a day higher than it was last year. It looks like U.S. gasoline can take 800,000 of that. Does that mean the rest of the world is not going to increase energy use with oil at half-off prices? I don't believe so.

**Mintz:** The other thing worth talking about is that shape of the energy futures curve was in backwardation. Nobody was really hedging fuel futures because they were trading at a discount to the spot market. Now we're in an environment that is a strong incentive to the exploration-and-production (E&P) companies to defer completion – which represents about 60 percent of costs – of wells.

**Cowart:** That's true. Shale-drilling is a two-part process: First, engineers drill a hole, set pipe, put casing in and then leave. A completion team comes to perforate the wells, to actually begin production. There are estimates there may be 3,000 or 4,000 drilled, but uncompleted, wells out there. Companies could sell the production forward, wait until service prices come down and – a year from now – go in and complete those wells.

**Mintz:** When the futures curve tells you to wait X number of months to get \$5 more per barrel for the oil ... well, you defer.

“ I believe we could see a 50 percent correction in the rig count, ... which sets prices up for a V-shaped recovery. ”

– Eric Mintz

**Cowart:** Absolutely. When companies are paying more to run their operations than they are making from it, that is an incentive to stop. If they believe help is right around the corner, maybe they keep doing it. But historically, the bottom in oil prices has been when it reaches

the cost to produce it. At these prices, it may make sense to hire a tanker, fill it up with 2 million barrels of oil, finance it at 3 percent, sell it forward and lock in profits when prices inevitably go up.

I can think of four or five things – problems in Venezuela, Nigeria, Iraq or Libya – that could take a million barrels of oil off the market in the morning. I cannot think of one thing that would bring on a million barrels. The supply-and-demand, and geopolitical, dynamics are in favor of oil price going back up unless you believe peace is going to break out all over the world.

**Abbott:** Let's discuss how you all have your portfolios positioned in light of these energy-related dynamics.

**Matt McGeary:** We are about equal weight in energy across our portfolios. We have tried, in the aftermath of the oil-price decline, to get what we view as higher-quality names. We haven't reached a point yet where we want to be overweight in the sector vs. the benchmark indices but I do believe there will be a time to do that.

**Chuck Schwartz:** We need to tread carefully in the small- and mid-cap names because larger companies will be able to weather this storm better than smaller companies. We historically have had greater exposure to service companies. They will be hurt with energy-related capital expenditures projected to go down 20 percent to 30 percent. The companies that benefit first in a recovery likely will be E&P companies, which could have a nice pop compared to the service names.

The debate among the team is when we might move more toward E&P companies and then, later, back to service companies. The timing is awfully difficult.

**Mintz:** I believe the market has an idea \$65 per barrel is the threshold for long-term oil prices. And so when we assess the small-cap E&P landscape, we see two buckets. There are companies that are going to do quite well in that environment and have the balance sheets to withstand the downturn. The rest of the companies have more dubious assets quality and balance sheets and are priced to go out of business.

There's a real crowding-out effect because there are only a few stocks that many small-cap managers want to own. Those stocks are the ones that people are clinging to as if they are life boats.

**McCallister:** The challenge we have in small caps, as Eric suggests, is finding companies with balance sheets that can tide over companies while the price situation sorts itself out. Few companies are currently earning any cash so the guy with the big balance sheet now is likely the winner when things turn.

Many of the infrastructure projects built over the last several years were financed by Wall Street, both through equity and debt. The challenge is finding companies that were either lucky enough (with their timing) or good enough (with their resources) not to have too much debt.

This has to do with the financials sector directly but it's energy-related: I would tread lightly in purchasing Texas-based banks or those with large loan books tied to energy-dependent companies.

**Cowart:** We have not given up on energy, especially in Equity Income portfolios. It's not clear what earnings are going to do but I believe values are pretty solid. Historically, when stocks have gotten to the level where they are today, that has been the bottom and there generally has been a nice recovery thereafter.

I am convinced that dividends – we are getting 4 percent-5 percent yields on some of these companies – are safe. I was quoted in a recent news article as saying, "Exxon would cut its chairman's salary before it cut its dividend." And I believe that's probably accurate.

We have continued to own what we view as high-quality names: companies with very little balance-sheet risk, strong operators, those with good resources.



**Richard Skeppstrom:** Last year's disparate returns among various sectors opened up some actionable valuation disparities. I had been overweight in banks and decided to move that overweight position to the energy sector.

**Camp:** First, I want to point out that long-term bonds yields and commodities both collapsed globally in 2014 and yet we still seem relatively sanguine. Those two things – to me – suggest there's some sort of trouble ahead.

The high-yield market is now much more exposed to energy – it is about 22 percent of the index – than it has been historically. Energy bonds are down 7 percent to 9 percent as one might expect but the high-yield market generally is holding in ... so far.

I have said for a few years now that advisors and investors who have chased yield simply to boost income likely are taking on inordinate risk when markets turn. I also have monitored master limited partnerships, which some investors have viewed as a cash-flow instrument. They, too, have seen dramatic downturns since oil prices have plummeted. It's important, in my mind, to remember that NOT being correlated to the equity markets is an immutable and most important tenet of fixed-income investing.



## Small/Mid Cap Core

### Chuck Schwartz, CFA

- 24 years of experience as a portfolio manager and analyst
- BS, University of Colorado (1985)
- MBA, University of Louisville (1989)
- Earned his Chartered Financial Analyst designation in 1999

### Matthew McGeary, CFA

- 16 years of investment experience as a portfolio co-manager and analyst
- BA, Kenyon College (1993)
- MBA, Indiana University (1999)
- Earned his Chartered Financial Analyst designation in 2001

### Betsy Pecor, CFA

- 18 years of investment experience as a portfolio manager and analyst
- BS, University of Vermont (1988)
- MBA, University of South Florida (1999)
- Earned her Chartered Financial Analyst designation in 2002

## Equity Income/Value

### Ed Cowart, CFA

- 43 years of investment experience
- AB, Dartmouth College (1969)
- Earned his Chartered Financial Analyst designation in 1977

## Large Cap Growth/International ADR

### Stacey Nutt, PhD

- 21 years investment experience
- 14 years of experience with current team
- MS, Carnegie Mellon University
- MBA, Queen's University
- BMath, University of Waterloo

## Fixed Income

### James C. Camp, CFA

- 26 years of investment experience
- BS, Vanderbilt University (1986)
- MBA in finance, Emory University (1990)
- Earned his Chartered Financial Analyst designation in 1993

## Small and Mid Cap Growth

### Bert L. Boksen, CFA

- 38 years of investment experience
- B.A., City College of New York (1970)
- M.B.A., St. John's University (1977)
- Earned his Chartered Financial Analyst designation in 1981

### Eric Mintz, CFA

- 20 years of investment experience
- B.A., Washington and Lee University (1995)
- MBA, University of Southern California (2001)
- Earned his Chartered Financial Analyst Designation in 2000

## Institutional Small Cap Core Team

### Todd McCallister, Ph.D., CFA

- 28 years of investment experience as a portfolio manager and analyst
- BA, with highest honors, University of North Carolina (1982)
- PhD in economics, University of Virginia (1987)
- Earned his Chartered Financial Analyst designation in 1996

### Scott Renner

- 23 years of investment experience as a portfolio manager and analyst
- BS, University of Florida (1990)
- MBA, University of South Florida (1993)

### J. Cooper Abbott, CFA, Co-Chief Operating Officer and Head of Investments

- 17 years of investment-industry experience
- B.A., highest honors, Brown University (1991)
- M.B.A., University of Pennsylvania (2001)
- Earned his Chartered Financial Analyst designation in 2014



880 Carillon Parkway | St. Petersburg, FL 33716 | 800.235.3903 | 727.573.2453 | [eagleasset.com](http://eagleasset.com)

E7092-3/15 Exp. 03/31/16

Past performance does not guarantee future results.

Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice, as are statements of financial-market trends, which are based on current market conditions. The meeting of Eagle's portfolio managers occurred Feb. 3, 2015. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable. Any index is referred to for information purposes only; the composition of each index is different from the composition of the accounts managed by the investment manager. An index is unmanaged and has no expenses, and it is not possible to invest directly in an index.