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# Thompson, Siegel & Walmsley, Inc.

INVESTMENT COUNSEL

**T**he price of a barrel of crude oil reached \$60 for the first time ever in June 2005. This event capped, at least temporarily, a rally from the stock market's mid-April lows and renewed heated discussions about the impact of sharply higher energy costs on the global economy and financial markets.

On matters relating to the energy sector, Thompson, Siegel & Walmsley, Inc. (TS&W) turns to one of our most experienced analysts, Jack Pickler, CFA, for patient explanations, cogent analysis and wise investment ideas. Jack is a Senior Research Analyst and a member of TS&W's Investment Policy Committee. Prior to joining TS&W in 2002, Jack's 25-year investment career took him from investment banking and "sell-side" research to a post as Director of Research at a major brokerage firm. At TS&W, Jack's research responsibilities include the energy sector, industrial companies and certain segments of the consumer discretionary sector. Jack is also an armchair technical analyst, which is a story for another day. He recently answered questions about TS&W's outlook for the energy sector.

**Q: Jack, the price of a barrel of oil has tripled since the beginning of 2002. Why have prices risen so high and so fast?**

**JP:** The answer comes from basic economics. Crude oil and natural gas are globally traded commodities. Prices are set by the forces of supply and demand. Over the past several years factors on both sides of the equation have driven oil and gas prices higher.

On the demand side, the world continues to consume more energy. Global consumption of oil and natural gas has risen about 2 percent per year for the past half century. In recent years, economic recovery in the US, which consumes about a quarter of total global petroleum production, has increased domestic oil and natural gas demand. More important though, is a surge in demand from developing countries, particularly China and India. Per capita energy consumption in these countries is only a fraction of that in the US and Europe but is growing at a double digit pace as those economies industrialize and consumer living standards rise. This is why global oil demand grew last year at the fastest rate since 1977. China alone was responsible for about 40% of global petroleum demand growth in 2004, and its appetite for energy is expected to increase.

**Q: What about supply? Aren't there plenty of oil and gas reserves around the world?**

**JP:** The supply story is more complex. Domestic oil and gas production has been in decline for at least twenty years, increasing our reliance on imports. Unfortunately, some of the world's most promising proven oil reserves—resources that can be economically developed—are in places experiencing either political instability or limited capacity to expand, or in some cases both. Nigeria, Venezuela and Iraq are major suppliers that have experienced political turmoil. Russia, the world's second-largest oil producer, has contributed much of the world's incremental supply of oil in recent years. However, it is currently facing declining production growth and political uncertainty that is impeding new investment. Saudi Arabia, the largest global supplier of oil, claims to possess ample spare capacity to meet growing global needs. However, some experts assert that the Saudi's largest fields are declining more rapidly than the Kingdom admits.



**We believe the fundamental outlook (for energy stocks) is positive and valuations remain attractive.**

- Jack S. Pickler, CFA

The world is not in jeopardy of running out of oil. The problem is that the oil we have is becoming more expensive to bring to market. The average cost of finding, developing and producing a barrel of oil is about \$35 and rising. The political battle over developing oil resources in the Arctic National Wildlife Refuge (ANWR) in Alaska demonstrates just how difficult it can be to bring resources to market. Over the last few years, healthy demand growth and tight supplies have caused energy prices to rise. I do not see these trends changing soon, so I believe the trend toward higher prices may persist.

**Q: We've also heard that speculators are behind the sharp run up in oil prices. Is there any truth to that?**

**JP:** Thirty to forty percent of the participants in the futures market for oil and gas are so-called financial players, that is, they are neither producers nor consumers of the physical product. I think these players probably do feed greater market volatility, but they also increase the liquidity of the markets, which is healthy. Liquid markets adjust more efficiently to changes in the fundamentals of supply and demand. I do think that the increased presence of financial players could produce higher highs and lower lows in the very short term, but the basic fundamentals of supply and demand remain the same.

**Q: So you think prices are in a sustained uptrend?**

**JP:** It has been TS&W's contention for some time that we are in a period of generally rising oil and natural gas prices due to the fundamental factors we just discussed. At the same time, it's important to remember that oil is an enormously volatile commodity, and its price is likely to fluctuate sharply. For example, oil futures for August delivery rose more than 30% from February to June. We think the top end of the range over the next year or so could be as high as \$70 - \$75 per barrel and the low end in the high \$30s to low \$40s. Within this range or channel, we think the tendency will be toward higher highs and higher lows.

#### A BRIEF HISTORY OF OIL PRICES (price per barrel in constant 2004 dollars)

		Price
March 1974	Arab oil embargo ends	\$50.79
1978-1979	Shah of Iran deposed, US hostages taken	\$67.98
1980-1981	Iran - Iraq war begins	\$85.16
1985	US domestic crude production peaks	\$49.22
August 1990	Iraq invades Kuwait	\$46.97
1998-1999	Asian economic crisis	\$10.93
Sept.-Dec. 2001	Aftermath of terrorist attacks	\$17.21
March 2003	US invades Iraq	\$25.40
June 2005	Global economic growth	\$59.63

*Source: US Department of Energy, Energy Information Agency*

**Q: What could cause a correction in energy prices?**

**JP:** The word correction implies that something is wrong with the price today, and that may not be the case. If what you mean is "What could cause prices to fall?" we have to look to supply and demand again. To see a reversal of the current price trend, we would need to see either substantial new production come on line or a significant dip in demand. Right now, neither seems to be in the cards. There are new oilfields coming into production over the next few years that will help some, but the lead times for these projects are quite long. The area that now makes up ANWR was first identified as an important petroleum reserve in the 1920s. Major new reserves are becoming harder to find and more challenging to develop.

A drop-off in demand could quickly lead to lower prices. At some point, higher energy prices should cause the world economy to slow, trimming energy demand and allowing the price to drop. In another scenario, rising energy prices could spark an increase in the inflation rate, triggering a spike in interest rates, followed by a slowdown in economic activity. Many analysts were of the opinion that this "demand destruction" would begin after oil

passed \$40 per barrel, but so far, even with oil near \$60, the global economy remains in a fairly healthy expansion. There is a point at which high energy prices would start a significant economic slowdown, but I do not think we have seen it yet. Keep in mind that the fastest economic growth and energy consumption is coming from developing countries, where energy demand is likely to continue rising even if economic growth slows in the rest of the world.

In the United States we have become far more energy efficient and, therefore, our economy is less sensitive to energy prices. For example, oil and gas consumption per dollar of economic output has declined by more than 30% in the last twenty years, which helps us absorb the higher price. Consumer outlays for all types of energy have declined from 5.7% of total expenditures in 1990 to 4.5% in the first quarter of 2005. Further, on an inflation-adjusted basis, oil and gas prices are still below the peak price of \$85 reached in January 1981. That said, oil prices cannot rise continuously without dampening economic activity at some point.

In the past, oil price spikes translated quickly into higher inflation, but that has not happened this time. The counter-inflationary forces of rising labor productivity and expanded trade in manufactured goods have offset the inflationary thrust from commodity prices, allowing interest rates to stay low.

TS&W does expect slower economic growth this year compared to 2004, partly due to energy prices, but we do not foresee a recession or a repeat of the “stagflation” that plagued our economy in the 1970s. We think the global economy will continue to grow, keeping energy demand and prices in an uptrend.

**Q: OK Jack, you've laid out a persuasive case for higher oil and gas prices, but isn't this already reflected in the stock prices? We've made money, shouldn't we be selling?**

**Q: The sector seems ripe for mergers and acquisitions. Are you looking for acquisition plays?**

**JP:** We base all sell decisions on valuation, fundamental performance and portfolio considerations. Right now we want to be overweight in energy stocks relative to our benchmark indexes because we believe the fundamental outlook is positive and valuations remain attractive. Earnings projections continue to increase for energy companies, particularly for the drilling and oilfield services firms. We have pared back some of our positions as the prices rose to diversify our holdings. Our preference now is to hold more names, with somewhat smaller position sizes, and to diversify across the different industry groups that make up the energy sector. We expect to cut back on energy stocks as the commodity reaches the high end of our trading range and to boost positions when prices fall back to the low end of the channel.

**JP:** We would not buy a stock just because we think it is a buyout candidate. It has to be attractive on its own fundamental business merits, and it has to be a good value. Nonetheless, some of the stocks we own for our clients are potential targets. Frankly, I have been surprised that we haven't seen more M&A activity. The large integrated firms have plenty of free cash flow, and it may be cheaper to find oil on the stock exchange than in the middle of the ocean. If current trends continue, I expect to see more buyouts, but it will not

**THE US HAS BECOME MORE ENERGY EFFICIENT...  
Energy Consumed per \$ of GDP**

<u>YEAR</u>	<u>ENERGY UNITS*</u>
1973	1,744
1981	1,443
1995	1,136
2004	920

\*Energy units= 100,000 btu

Source:

US Department of Energy, Energy Information Agency

necessarily be the smallest pure plays in a particular business or geography. Some of the largest North American exploration and production companies are now considered acquisition candidates.

I like the oilfield services and drilling companies in particular because they have the power to raise prices. The energy industry faces a global shortage of equipment, engineers and other personnel, and capacity is growing slowly. For example, at the peak of the last oil boom in 1984, there were 5,000 drilling rigs operating in the US. Today there are only 1,500. In addition, services companies are the only way to profit from spending by the large national oil companies, like Saudi Aramco, which own most of the world's known oil reserves. Refiners also look interesting. The US has 149 oil refineries today, down from 324 in 1981. Total refinery capacity has declined by 10%, requiring us to import more refined products. Since refinery capacity is likely to remain tight, I believe refiners will continue to enjoy pricing power, strong profit margins and healthy earnings trends.

**Q: If you like the sector so much Jack, why not own a lot more energy?**

**JP:** We may own more, but only at the right price for the commodity and the stocks. Right now, our large cap benchmark indexes range between 8.5% energy (the S&P 500) and 13.5% (the Russell 1000® Value Index). Our current target is about 14% of portfolio value, but we would move to a higher weighting if prices declined and vice versa. We expect to take advantage of the trading range.

I see two reasons for discipline when it comes to energy stocks. The first is simply the volatility of the commodity. We do not want to subject our clients to the possibility of an oil price collapse, even if that is not what we expect. We employ risk controls that require us to maintain broad diversification and limit the extent to which we can overweight a sector, no matter how much we like it.

Second, I keep an eye on ownership trends. This is not an under-owned group like it was three years ago. Most large institutional investors are now "market-weighted," which means their portfolios have the same exposure as the market indexes. When most big investors already own a group there are fewer natural buyers, and my contrarian instincts urge caution.

**Q: So to sum it up, Jack should I trade in my Hummer and hang on to my energy stocks?**

**JP:** (Laughs) Well, at least one will be a good hedge against the other.

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