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Energy as a potential portfolio component of a durable income strategy

Investments in energy, particularly oil and gas investments, can serve as a component of a durable income strategy, and thus may warrant an allocation within a diversified investment portfolio. A durable income producing portfolio that includes an allocation to oil and gas investments is designed to provide investors:

- Current income
- Attractive absolute and relative return potential
- Diversification benefits
- An inflation hedge

Within the energy sector are a wide range of investment opportunities, each with different cash flow and asset characteristics. These subsectors include exploration and production, midstream and energy services.

U.S. energy independence: once thought impossible, now projected to occur within two decades

Recent U.S. crude oil production activity suggests a promising future for the U.S. energy industry. 2009 to 2011 marked the first time the U.S. experienced three consecutive years of crude oil production increases since the early 1980s. This growth, spurred by the shale revolution, is leading the U.S. toward energy self-sufficiency. According to the U.S. Energy Information Administration (IEA), the U.S. could surpass Russia and Saudi Arabia as the world's leading producer of oil by 2015. The IEA has also stated that the U.S. is on track to become fully energy independent within the next two decades.

The positive economic and political implications of this movement toward independence are profound: the trade deficit, 40% of which currently comes from energy imports, could potentially reach equilibrium if not an eventual surplus, which would increase U.S. GDP, possibly strengthening the dollar and reinvigorating domestic jobs and manufacturing.

Energy – an attractive investment

The long-term fundamentals of the energy industry are compelling. Due to historic under-investment in the infrastructure of almost all sectors within the energy industry, there is a need for significant growth and development capital to meet future demand. Moreover,

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due to the manner in which energy is sourced, distributed and regulated, many industry participants are seeking partnerships or alliances to rationalize their operations, fund additional growth, or divest oil and gas producing assets outright. This is another significant driver of the demand for investment capital. Because infrastructure has failed to keep pace with the changing requirements of the global energy system, there is, within many segments of the energy industry, room for new entrants.

Larger energy companies are increasingly focused on core competencies, return on capital, and preserving balance sheet strength, which compels them to deploy their capital on large-scale projects. In certain cases, opportunities arise to take advantage of these companies' need to divest smaller, non-core businesses in order to focus on large, capital intensive projects.

Energy transactions often require large amounts of capital – capital that debt capital markets are not typically well suited to fund. Exploration and production, midstream, and other growth investments can also produce substantial returns using minimal leverage. This makes energy an attractive investment opportunity throughout economic cycles as investment performance is neither driven by high amounts of leverage, nor dependent upon strong debt capital markets – an important characteristic of durable income portfolios.

The shale revolution

A significant catalyst of change over the past several years has been the increase in U.S. oil and gas production from shale rock formations — a trend commonly referred to as the "shale revolution." Breakthroughs in horizontal drilling, hydraulic fracturing (known as "fracking") technologies and associated production methods have made large-scale oil and gas production not only easier and less expensive, but also politically and economically compelling. Oil and gas resources that, only a few years ago, were considered to be either not cost-effective or were logistically impossible to recover, are now being extracted efficiently and profitably.

Technological advances have cause the U.S. to refocus on the oil and gas business, with many industry players rushing to acquire and "prove" acreage, thereby driving growth in demand for energy services and necessitating the expansion of midstream infrastructure. Many major petroleum companies are shifting their attention to the shale opportunity. These entities continue to sell attractive portfolios of proven oil and gas assets, using them as a source of liquidity to fund shale-focused initiatives. The conventional portfolios of oil, gas, and other assets being sold to raise capital for shale drilling and other new initiatives may present unique investment opportunities for the retail investor.

Opportunities in the oil & gas sector

Within the oil and natural gas sector, opportunities arise from acquiring working interests in oil and natural gas reserves. While these investments come with risk, they also have the potential to provide periodic income, and offer attractive absolute and relative return potential, as well as hedge against inflation. In other words, these investments bear distinctive features which, when properly combined, could be an important component of a durable income producing portfolio.

Although oil and gas investments involve exposure to commodity prices, it is often possible to reduce this exposure through hedging or longer-term commercial contracts. In the exploration and production sector, hedging proven, developed, producing reserves may produce

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a base cash flow stream and promote durable income returns to investors. Within the oil and gas sector, independent exploration and production companies ("Independent E&Ps") are involved exclusively or primarily in recovering or producing crude oil and natural gas. Independent E&Ps are directly exposed to the price of oil and gas. This exposure is often managed through active hedging strategies. Operating costs for Independent E&Ps are driven by factors often unrelated to the price of the commodity that they produce. Therefore, these companies often possess significant operating and commodity price leverage, generating stronger cash flow and earnings.

Durable income portfolios derive their returns from active management. There is a clear opportunity for high-quality management to add value upstream as many "smaller" fields are capital starved, neglected, or not managed by experienced professionals. The ongoing consolidation and rationalization programs being undertaken by the "super-majors," i.e., some of the largest Independent E&Ps, continue to create investment opportunities for other Independent E&Ps.

Conclusion

Energy investments have their foundation in multiple drivers of return, are resilient to changes in credit and market risk and to macroeconomic conditions, and may serve as one of the building blocks of durable income programs. These investments afford the opportunity to achieve attractive risk-adjusted returns, cash flow and real asset exposure. In addition to seeking to provide a steady current income and low volatility, energy funds have little correlation to other investments. This furnishes valuable portfolio diversification benefits.

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