

Commodities Investing Part II: Oil and Gas

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“Advice is like snow – the softer it falls, the longer it dwells upon, and the deeper it sinks into the mind” - Samuel Taylor Coleridge

Most portfolios holding stocks typically have a connection or association to the oil and gas industry. Equally as important, most portfolios hold a large number of companies that consume energy and would be affected by a sharp rise in oil prices. Thus, it would serve a portfolio well to have a focused concentration in energy. As a hedge against the impact of rising oil prices, this type of diversification could function as a source of increased return to a portfolio. TPI has integral working relationships with several experienced firms that offer investment opportunities in all of the stages of energy exploration, drilling, refining and distribution. In this article, we will discuss the reasons why investing in this asset class can provide both return and diversification.

Oil and gas investments can provide a hedge against rising prices. If petroleum prices are high and consumers are paying more at the gas station, returns from investments in oil and gas can offset rising costs. These investments can also provide a hedge against movements on stocks or interest rates. Despite similar volatility, equities and commodities have rarely fallen in the same year, and in fact move in opposite directions.

Oil has become the 'new gold'! It is a financial asset in which investors seek refuge as inflation rises and the dollar weakens. Oil and gas prices are in the news almost every day and in our thoughts every time we fill up our vehicles. Prices are driven by many factors, one of which is the increasing need for many commodities from China, India, and other emerging market countries. These countries need oil to support manufacturing and infrastructure development. Recent natural disasters in Japan and New Zealand have created a sudden higher demand, and it is straining existing supply and production. US investors are beginning to realize that these assets are not renewable. As the supply is depleted, the inherent cost of the commodity rises.

There are a number of investing strategies in the oil and gas industry. Investment in exploration and drilling is usually done through partnerships. These partnerships are formed by a drilling organization that is raising capital to drill in a limited geographical area, either on land or offshore. There are several tax advantages to this form of investment. Ultimate returns are based on the firm's operating skills and its ability to identify potential sites that have adequate deposits of oil or gas. Understanding the technical aspects and inherent risks in this area of investing is very difficult for the individual investor. TPI runs the due diligence for our clients, with extensive and careful analysis of each potential investment opportunity .

Investors can also participate through Private Equity Firms, which buy petroleum reserves and create a company to process it. There is usually a sponsoring organization assisting in the process, some of which have gone on to become publicly traded companies. Investors also have access to royalty pools. By obtaining royalties, the investors receive a share of the selling price of the commodity. Since, the royalty owners do not contribute to the costs of drilling, they have

virtually no control over operations. Pools of investors diversify their investments across multiple regions and geological ideas, thus reducing volatility and risk.

A more common mechanism of investing in oil and gas is through Private Equity Funds. The participants in these investments work alongside operators, but utilize fund managers who bring experience and sophistication to the team. They assist with everything from financing to exit strategies. Their portfolios may include pipelines, investments in oilfield service companies, investment in private or small publicly-traded oil and gas companies, or oil and gas processors.

Previous TPI articles have discussed ETF's and mutual funds. Some ETF's and mutual funds invest primarily in major oil company stock, medium-sized oil and gas companies, or independent firms. These investments carry far less risk, but conversely do not have the same reward potential.

TPI utilizes various commodity Funds and ETFs in our 7Twelve strategy. We also provide direct access to focused energy investment opportunities through private offerings. Please contact our office should you have the desire to learn more about our oil and gas private offerings.