U.S. BUYSIDE

Encouraged by the way many E&P management teams successfully maneuvered through last year's financial crisis, U.S. buysiders are bolstering their energy portfolios again.

ARTICLE BY BERTIE TAYLOR

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Excerpted from

Investor

June 2010 Copyright[©]Hart Energy Publishing 1616 S. Voss Rd. Suite 1000 Houston, TX 77057 (713) 993-9320

he global financial chaos and low commodity prices that plagued late 2008 and most of 2009 left much of the investment community in limbo, eager for signs of recovery. In the interim, several prominent institutional investors quietly reduced their exposure to energy stocks. This year, some have opted to leave their energy weighting low, still smarting from the market crash and skeptical about gas prices and ongoing reforms on Capitol

But other buysiders are taking a more strategic, optimistic view, seeing valuable investment opportunities in the major integrated oils, independents with seasoned management teams and "underdog stocks" Wall Street may be underestimating. These buysiders are applauding many energy companies for applying lessons learned to their balance sheets and asset-development strategies.

And, while buysiders investing in energy aren't immune to what's creating industry buzz—unconventional assets and oil-weighted E&Ps—many are reluctant to exchange foundation beliefs for what's in fashion. Now that buysiders are looking again, are they valuing companies based on assets, balance sheets or just commodity prices? Here, six buyside firms discuss current investment strategies, holdings that are exceeding expectations and energy subsectors poised to outperform this year.

Sell winners, buy losers

Greenwich, Connecticut-based Sound Shore Management Inc. was founded in 1978 and has kept the same investment structure over the years. The independent investment-management firm manages about \$7 billion in assets. One-third of this is in its mutual fund, the Sound Shore Fund, and two-thirds make up funds the firm manages for institutions. At year-end 2009, energy investments represented 19% of its portfolio.

"There are four things that differentiate us as an investment firm," says Jim Clark, Sound

Shore's analyst responsible for its energy investments. "One is our focus. It's hard to find 32year-old firms that still do one thing. Our goal is to be the best value-investment firm around and we feel we can do that through our 40-stock portfolio. The second thing is our independence. We're owned by the partners, and answering to our clients and ourselves at the end of the day gets us to zero in on picking the right stocks for the portfolio. Or, if we make mistakes, we reckon with them and move on. The focus and

independence allow us to stay as contrarian as possible about stocks.

"The third thing is our investment process. We call it disciplined fundamental value. It starts with a valuation screen, and then includes detailed fundamental work from our seven-person investment team. Finally, we are significant investors in the fund, including our employee profit-sharing program that's entirely invested in the Sound Shore Fund."

Clark says his team is bottoms-up in all sectors, meaning they don't start off with a macro view and then work into the stocks. Instead, their process starts with stock-specific research, and then moves toward a macro view. Though the commodity markets were very volatile during the past few quarters, he says Sound Shore has stuck to a strategy of "selling winners and buying losers."

Price volatility allowed the firm to pick up stocks "that are terrific franchises at low prices," Clark says. While the firm was selling some of its energy positions in the first half of 2008, by the fourth quarter of that same year a lot of buying opportunities with attractive valuations surfaced, he adds.

"As value investors, we're much more inclined to invest in names when prices are down, and we prefer to take one risk at a time. Generally speaking, we look at out-of-favor stocks, which are going to have issues. If we're talking about an operational issue that management is focused on fixing, then we're willing to take that operational risk as long as we know we



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have a balance sheet and business model that lends itself to stability. We like limiting the types of risk we take on with each investment."

The analysts at Sound Shore pay close attention to a company's valuation, and where it stands compared with its historic norms. They also look at financial performance relative to history. The group actively invests in companies that are in the bottom end of their valuation range to take advantage of mean reversion, an investment approach that suggests prices and returns eventually move back towards the mean or average.

e also spend a lot of time with primary research sources. We won't buy a stock until we've talked to the management team. We even talk to competing management teams and field consultants—anybody who can give us insight about the company. Finally, we come up with a financial model that helps us see the earning power of a company and the risk/reward value."

Energy holdings that are exceeding the firm's expectations include ConocoPhillips Co., which is in the middle of a fairly significant restructuring. The company is expected to sell \$15- to \$20 billion in assets during the next 24 to 36 months, and Clark expects some of the proceeds will reduce debt and fund share buybacks. Historically, many of the integrated oils have performed well during a restructuring, he points out.

"It's really an improving return-on-capital story. As the returns on capital move up, it will realize a higher multiple in addition to the earnings growth we should see in the next two to three years. We expect price-to-cash-flow multiples to also expand as they get higher returns."

Marathon Oil Corp., which is more exposed to refining and marketing, is also a Sound Shore holding. Currently, there's a lot of confusion on Wall Street about the earnings power of the company, Clark says. It just finished a massive capital-spending period and recently built a large expansion in the Gulf Coast at its Garyville refinery. It also has had some down time in its E&P business, particularly in Equatorial Guinea and Canada.

"We think those assets are going to come back on stream during the second quarter. Off of a very low fourth quarter and first-quarter 2010 in oil production and refining profitability, we expect to see substantially improved earnings power."

He points to the service industry and shale players as energy subsector winners last year; this year it's the large integrated majors that have some refining, are doing restructurings and improving financially. Several companies with greater oil exposure were winners for the firm last year, but Sound Shore analysts are reluctant to assume all oil-oriented companies are good investments.

"We still look at investment potential on a company-by-company basis—we're not invested in Conoco and Marathon for the same reasons. We take the approach that if oil and gas prices and refining margins stayed flat going forward, 'will this stock outperform?' We look for a company's specific drivers that will make the stock go up even if we have a flat commodity environment."