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Energy Update

Investment Strategy Update

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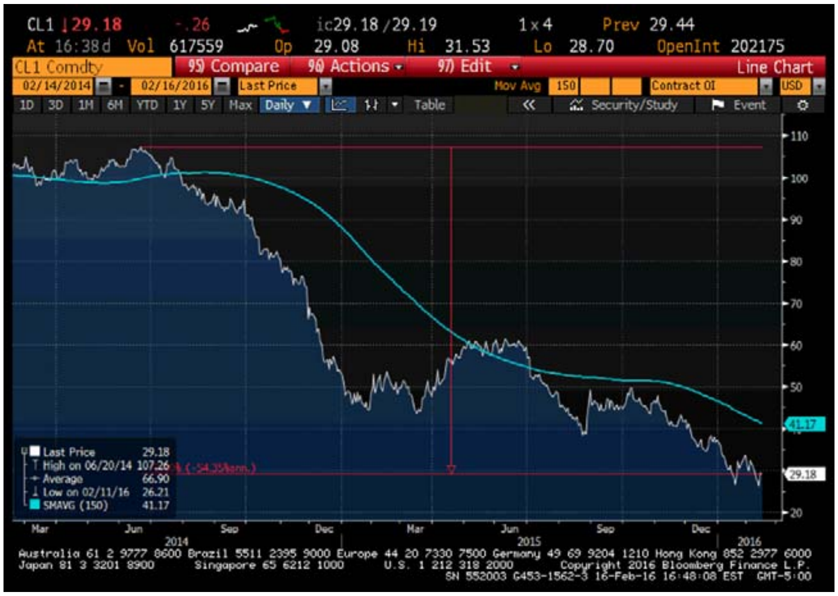
What's Up

In January, we wrote that market participants feared a watershed event of some sort, and that this event would result in market dislocation. In the past four weeks, these fears have found a focus in the energy sector, as oil prices declined from $37 per barrel at the end of December to $26 in mid-February: a 30% drop. And as thought, markets have become dislocated.

Some Background

The decline in oil prices started a cascade that is flowing through the financial markets.

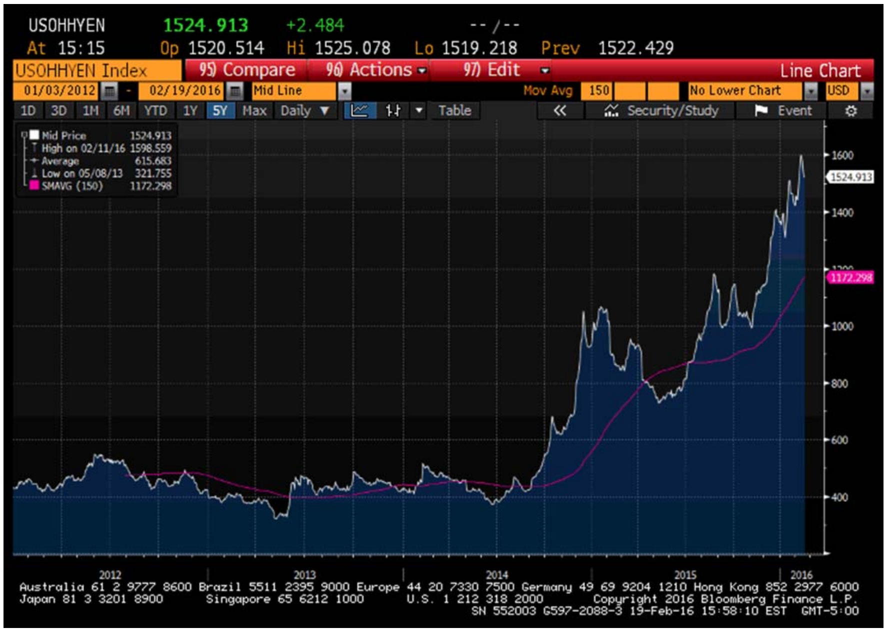
West Texas Intermediate Crude – Last 2 Years



It first hit equities. The share prices of independent exploration and production companies, and MLPs, declined precipitously. Declining share prices meant that these companies could no longer attract capital in the equity markets. This left them dependent upon the debt markets for funding.

Being highly dependent upon the debt markets was not a good thing. Debt investors began to question the ability of the smaller High Yield (a/k/a Junk) rated borrowers to cover interest and principal payments. As the price of oil fell, so did the price of high yield energy bonds. Spreads widened by 200 basis points from already elevated levels at year end.

High Yield Energy Spreads

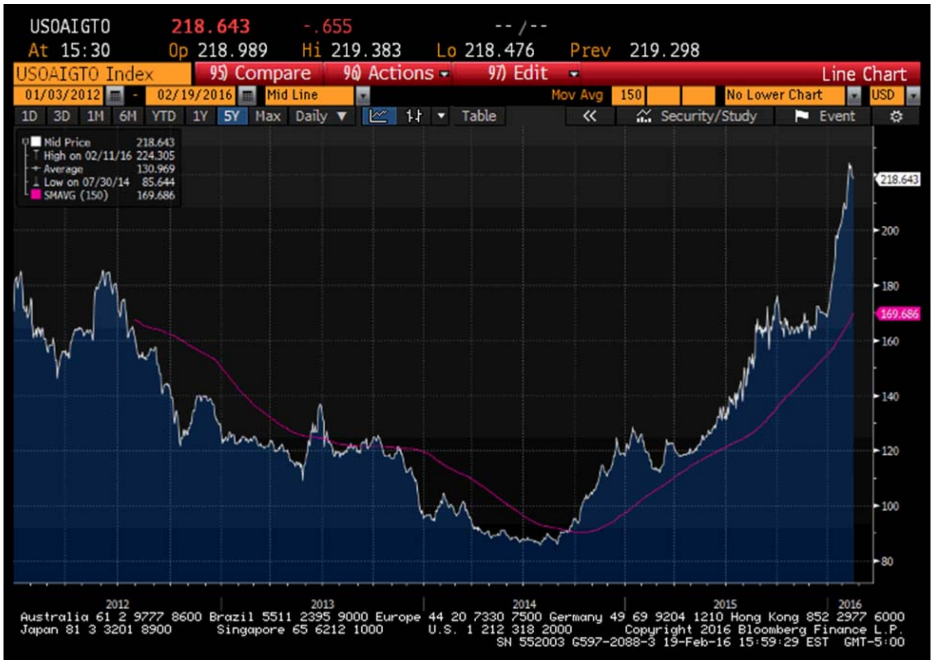


Eventually, price declines became such that investors had to sell, either to reduce risk in their portfolios or to meet redemption requests. This is when the cascade of sales began to impact bonds of the investment grade energy companies—both majors like ConocoPhillips and Occidental Petroleum, and the international “supermajors” like Royal Dutch Shell and Chevron. Portfolio managers are seeking to reduce Energy exposure; with few people willing to buy junk-rated energy bonds, they are forced to sell liquid investment-grade issues.

Meanwhile, regulatory changes implemented since 2008 have caused declines in bond market liquidity. Banks are no longer as willing as they once were to buy bonds for inventory. The seller of a bond may now depend upon finding what is called an “end buyer”—a money manager, an insurance company—willing to buy it. As a result, trading has become choppy, and the spread between the bid and ask price has widened.

This decline in liquidity coupled with selling pressure is now causing dislocation to spread to the broader investment-grade bond market. As available liquidity is sopped up by energy issues it becomes more and more difficult to find buyers for bonds of manufacturers, pharmaceutical companies, railroads and the like. We can see this reflected in widening spreads across all asset classes.

Investment Grade Spreads



How Does This Impact You?

Historically, Investment Grade energy is one of the most stable parts of the bond market. There have been some company-specific events: such as the 2011 Gulf of Mexico oil spill, which caused a sharp drop in the price of BP bonds. But on the whole, the sector has weathered ups and downs in the economy—including the 2008 crisis—rather well. Exxon's triple-A credit rating, first assigned to the then-Standard Oil of New Jersey in 1936, and unchanged ever since, is probably symbolic of the whole.

Any sector whose debt is backed by hard, physical assets generating predictable cash flows will be attractive to a manager of fixed income portfolios. Oil fields, drilling rigs, ships and tank farms are the hardest of hard assets. And petroleum is the basic building block of much of modern industry, both as fuel and as chemical feedstock: there is always a market for it.

As a result, our portfolios maintain a representative exposure to the oil sector. As we explained, the prices of these bonds have declined. This means that these positions are showing an unrealized loss.

What Are We Doing?

In response, we've conducted a thorough fundamental review of our energy exposure.

We first performed a detailed examination of the balance sheets and income statements of our portfolio companies. We then reviewed the companies' ability to conserve capital by cutting stock buybacks, dividends and capital expenditures. We factored in their potential to conduct asset sales in order to raise cash. Finally, we built models to test their ability to cover interest and principal payments under a variety of circumstances.

Naturally, the largest variable is the price of crude. The longer it remains at or below current levels, the greater the financial pressure on all oil participants.

We came to two conclusions.

First, we are comfortable with our current holdings. Prices will remain volatile and dependent on corporate actions as well as crude prices. Ratings-agency downgrades are quite likely. Second, market dislocations and selling pressures are causing the bond market to throw the proverbial baby out with the bath water. Some bonds are trading at levels that do not seem justified by the underlying credit fundamentals of the company. We will likely add these bonds to portfolios wherever appropriate.

Final Thoughts

In the last five years we have seen dramatic changes in the way oil is produced globally. For the first time in living memory, the swing producer of oil is not a sovereign government or a former component of the Standard Oil trust. Spare capacity is now in the hands of a multitude of independent American and Canadian oil producers. Each of them has a different cost of production and view of the world; none of them are deciding to produce based upon the dictates of OPEC headquarters in Vienna.

It took decades for the old cartel-based world of petroleum production to develop. It will take at least a of couple years for the market to adjust to the new reality. In the meantime, volatility will be a fact of life in the oil markets. Equity prices and fixed income spreads will reflect this uncertainty.

Finally, it is important to remember that we are bondholders. This means we are creditors of the company. Our claim to the assets is senior to that of the equity holders. And these assets do not consist of a securities portfolio or a derivatives book. These are actual, physical assets: oil wells, drilling rigs, pipelines, tank farms, railroad cars, ships. They are not going to evaporate because of a bank run, as occurred in the financial crisis of 2009.

We would be happy to discuss anything in this note with you in greater detail. Please don't hesitate to contact us to schedule a call, should you wish.

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