

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Long-Term Investing in Energy Equities



**TIM GUINNESS** is Chairman and Chief Investment Officer of Guinness Asset Management Ltd. and Guinness Atkinson Asset Management, Inc., both founded in 2003. Previously, he was Chief Executive of Guinness Flight Global Asset Management Ltd., a fund management business focusing on long-only investing in equities, bonds and currencies globally. This was acquired by Investec Plc in 1998. Mr. Guinness continued for a period at Investec in a senior management position but also returned to hands-on fund management, and in 1998, started running a small energy fund called the Investec Global Energy Fund. In 2008, he launched the Guinness Global Energy Fund, which is currently a \$400 million fund. He has an M.A. in engineering from the University of Cambridge and an MBA from the Sloan School of Management at the Massachusetts Institute of Technology. His financial career began at Baring Brothers & Co. in 1970. He moved to Guinness Mahon in 1977.

### SECTOR — GENERAL INVESTING

**TWST:** Before we get into the details of your fund, please tell us why you believe right now is a good time to be investing in energy.

**Mr. Guinness:** To answer the question properly, I think there are three scenarios you have to consider. We first have to say: How will energy shares fare in a double-dip recession scenario? Here, there are the following important things to say: There are two unique commodity features about energy markets that give energy equities value-protection characteristics. The first is that the OPEC and Russia monopoly capability to create a floor under \$80 oil is a very valuable and too-little-commented-on protection for investors. The second is the extreme cheapness of U.S. natural gas, where in particular we think that the U.S. natural gas price now at \$4 is right on its back. In the short run this has happened because of a supply shock — the very interesting breakthroughs in horizontal drilling

and fracking that are allowing gas shales to be developed. This has short-term unbalanced supply and demand, but we are absolutely convinced that fundamentally the marginal cost of the marginal cubic foot of gas, 1,000 cubic feet of gas, is actually well above \$4. In fact, it's nearly \$6. The floor under oil and cheap gas are two important deriskers for energy investors.

Then there is another double-dip recession positive for energy equities, which is that they give a good exposure to what's going on in emerging economies. Really emerging economies — China, India, Africa and Latin America, the resource-rich countries — are driving energy demand and many energy companies' businesses are driven by this. Emerging economies reach a tipping point when incomes get to \$3,000 per head. What's happening there is a lot more important than what's happening in the troubled, developed world. So that's the double-dip recession scenario. It means that this chunk of any equity portfolio has, in our

view, got good downside protection. By the way, it doesn't mean that they won't dip off in value, but these characteristics will of course then recover quickly from any market weakness.

Then we come on to the next scenario, if we get not a double-dip recession, but a continued slow recovery. I should say that this is, in my own view, what we're most likely going to see unfold. I believe that the recent pessimism fever that has caught hold among a lot of the investors — and indeed, other commentators and politicians — is very much overdone. I think that the business cycle forces that exist, let's say in the U.S., will be the engine for this. By which I mean that eventually housing starts, which are really on their bank languishing now, will start to recover. They always do. And then eventually, vehicle sales will pick up from their pretty anemic 12 million cars a year and go back to a more normal 16 million.

The consumer, meanwhile, has already rebalanced his spending. The savings rate has gone up. That's a key one-off adjustment. We're left with the government deficit. In my view, solving that will cause a headwind going forward, but it will increasingly be offset by the business cycle beginning to kick in. So we don't believe in a double-dip, we believe in continued slow recovery.

In this world, we think energy equities offer fantastic value. Markets continue to slowly recover. Confidence is going to seep back in and energy equities are very cheap on price/earnings multiple terms, very cheap in terms of their current valuations relative to net assets behind those valuations as compared with where they have been historically for many years. And there's also the standout dividend yield of a number of the super majors, and you've got the services sector, which

both in gas shale and in oil shale. You've also got as a last point, one of the points I mentioned before, which is exposure to growth in energy demand in emerging economies. As I mentioned, many of your U.S. oil and gas companies have got significant exposure to what's going on in the emerging world.

Lastly, let's imagine a different world. This is a third scenario investors have got to think about. What happens if inflation takes off? Energy equities are one of the real places to

hide, along with gold and index-linked bonds. I've just been looking at the long-run ratio of oil, gold and property. It's very interesting how if you go back to, let's say the 1960-1970 period, gold was around \$35. A few months ago, it was trading at \$1,400. It's now gone up rather higher, but just to make my point, I'm going to get back to that moment, when it was up 40 times. I wondered how much oil has gone up over that time period. Well, if you go back, oil was trading at about \$2 a barrel in 1970, and it was then trading at about \$80 four months ago, so it had gone up 40 times. I then decided to look at what has happened to the real value of property. I happened to look at U.K. property prices, and they've gone up 35 times measured in U.S. dollars. What's happened in the last, I suppose, 12 to 18 months is that actually gold has recently begun to accelerate away from oil. It's again beating to a slightly different drum. But if you're worried

about inflation, oil is a real asset. We also make the following point to people — we think that over the next 10 years oil is going to trade, in today's money, somewhere between \$80 to \$100 a barrel. But if you adjust for inflation, you'll find in nominal terms you'll be getting \$150 to \$200 a barrel in 2020 with quite modest inflation.

### Highlights

*Tim Guinness discusses the strategy at Guinness Atkinson Asset Management for investing in energy, and he invests in value with a longer investment horizon. He shares some of his top holdings and his sell discipline. He offers reasons why he recommends energy equities regardless of a double-dip recession, slow-growth recovery and a potential increase in inflation. Mr. Guinness also shares insight on the macroeconomic factors which he believes create opportunities for energy investors. Companies include: Exxon Mobil Corporation (XOM); Chevron Corp. (CVX); ConocoPhillips (COP); BP plc (BP); Royal Dutch Shell plc (RDSA); Energis S.A. (ENI); Total SA (TOT) and Hess Corporation (HES).*

***“There's a series of different reasons why energy equities are a good place to put quite a bit of your equity capital today, whether we have double dip, slow growth or inflation.”***

was beaten down in 2009 and 2010, but began to recover in the second half of 2010, actually beating to quite a different drum to much of the rest of the economy. There's a very distinct uptick now in the oil and gas service company business cycle. So those are all strong positives. We've then got interesting growth opportunities arising from these new horizontal fracking developments enabling us to get energy out of shales, and they exist

To recap, there's a series of different reasons why energy equities are a good place to put quite a bit of your equity capital today, whether we have double dip, slow growth or inflation.

I should next deal with some other questions that are sometimes put to me: What about ETFs? First of all, energy commodity ETFs, the oil and natural gas commodity ETFs are very toxic. I don't know how familiar you are with contango, but it can

just eat up investor value. Contango in the futures curve is when the futures curve is rising over the months ahead. For any ETF to stay invested, it has to roll the futures contracts it holds monthly, and you can lose 1% or 2% of your investment every time it rolls because of contango.

Alternatively, when you look at energy equity ETFs, it just turns out they underperform against active funds. We did an exercise recently where we looked over the last seven years — the period since I launched my U.S. fund — at how all the actively managed no-load energy funds had done compared with all of the energy equity ETFs. Of the eight actively managed funds, six of them outperformed every ETF, and there were two that underperformed the best performing ETF. But the remainder of the ETFs, there were about five, underperformed all the active funds, so there you are.

***“Then how do we select 30 names? About half of the decision comes from what sectors I like, thinking about which bits of the energy universe look interesting today and look cheap.”***

**TWST:** Would you give us some more insight into your investment strategy as it pertains specifically to your Global Energy Fund? What are the subsectors within energy that you believe have the best opportunities right now, and are there any that you’re staying away from?

**Mr. Guinness:** Let me just start by mentioning a couple of important things about the way we run the Fund. We start off with a belief that if you hold a portfolio of equally weighted positions, and I started with 25, I now have 30 equally weighted positions. That is a very good portfolio construction. It diversifies specific stock risk away to a reasonable extent. We never have 10% or 15% in any one position. They are all equal at only 3.3%. So the maximum we can lose if a position blows up is around 3.3%.

It also gives us a very powerful sell discipline. Whenever we buy something, we have to sell something — that’s our rule. Many investors are bad at selling, and this helps a lot. However, we equally don’t believe in high turnover. We tend to buy stocks that we think are good value and then hold them for two or three years until the reasons that we’ve bought them get justified. Obviously, sometimes we don’t get it right, then we will capitulate. But on the whole, we believe that excessive trading — or indeed, much trading at all — is just expensive. It racks up cost for our investors, so we try and keep our cost down by keeping it low.

Then how do we select 30 names? About half of the decision comes from what sectors I like, thinking about which bits of the energy universe look interesting today and look cheap. I mentioned that there were bits of the service sector, the oil and gas service sector, that we are interested in. We’ve

had a not huge but deliberate exposure to pressure pumping, which has been one of the main beneficiaries of the recent gas shale drilling innovations where horizontal drilling and fracking of shale have transformed the economics. Pressure pumping is core to fracking. So that’s a sector we like. And more generally we have found some quite interesting investments in other service companies that could benefit from the explosion in horizontal shale drilling. On the other hand, we have not been favoring offshore drillers who have been quite adversely affected by the knock-on effects of the Gulf of Mexico Macondo spill and where there’s still quite a big pent-up pipeline of new offshore drilling vessels and platforms coming into the market, which is bad for the pricing ability of offshore drillers. To look at another theme, we find the boring integrated companies today actually stand out in value terms.

**1-Year Daily Chart of Chevron Corp.**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

The only super major that we don’t own at the moment is **Exxon** (XOM). Within that complex, **Exxon** offers relatively the least value. I think that maybe because **Exxon** is so big, it’s seen as a safe haven. So its shares get quite a lot of money from investors who just feel safe there, but it means its stock gets pushed up and tends to be too expensive for us. But we like most of the rest of that complex, and I’m talking about **Chevron** (CVX), **ConocoPhillips** (COP) and the Europeans, and there we particularly like **BP** (BP). We think it’s again a standout in value terms despite the negative publicity it’s had on Macondo and Russia. We also like **Shell** (RDS-A), **ENI** (ENI) and **Total** (TOT). We also like **Hess** (HES), a U.S. midcap integrated, which is building a great international business. So integrations represent an area we’ve got a reasonable positioning.

Then we've got some money in Canada. We think the oil sands are a good, long-term investment. We hold about 10% of the Fund in Canadian stocks that give us the exposure there. Why do we like the oil sands? Because they're growth companies. While your **Exxons** and **Chevrons** are really finding it difficult to raise their production by even 1% a year, these Canadian companies are ramping up production at 10% or 15% a year, and that's going to go on for another seven or 10 years, although we have been taking a bit of money off the table there whenever the oil price spikes. These companies obviously benefit from a high oil price, but we are happy to take profits whenever the oil price gets ahead of itself. We see \$85 as about the right price for oil.

1-Year Daily Chart of ConocoPhillips



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

Another theme for us has been scouring the world for lesser-known independents operating in more remote regions. We've got positions in companies active in Vietnam, in Thailand, in Turkmenistan, in West Africa and Colombia. In total, we've got a little basket of six of these attractive stocks representing about 10% of the Fund. I should explain that although we have 30 positions in total, because these companies are slightly riskier positions, we've actually split positions here between two companies each time we've made these types of investments.

**TWST: What triggers you to sell a stock?**

**Mr. Guinness:** I said earlier that I think investors are generally quite bad at selling. Therefore, you've got to do everything you can to help yourself do it better than that. So we've got this rule, whenever we want to buy something, we will sell something, and then I guess we force ourselves to say, "We like every stock we hold, but we just like this one a little bit less than the other ones." Now, how we do reach that conclusion? We certainly look at how they've performed and any stock that has moved up between 50% or 100% over the last 18 months comes right onto the radar screen as a sale candidate. Such a company has done very well for us. Do we still think it offers enough value to hold on to it? To support this discipline every month, we explicitly review the big movers.

The second discipline we have is that we screen a universe of 350 stocks around the world every week, and we screen them for four things. We screen them for: Are they good companies? To determine whether the company is a good company, we look at its return on capital over the last five years, and if their return on capital has been good, we say, "We don't know what you're doing right, but you're doing something right, there is something good about you. Maybe you're lucky or you're in the right place, maybe you've got very good management or whatever. For whatever reason, you are a good company." But the trouble is you often find that good companies get overpriced. So we then are very anxious to find good companies which are good value, i.e., we're looking for good companies that are cheap. There aren't that many of those around. How do we decide on whether companies are cheap? We do an evaluation using two metrics. We will look at the enterprise value to EBITDA ratio over five years, i.e., over the cycle because one of the problems with analyzing energy companies is just that — they are quite cyclical. We have to avoid being lured into a company

1-Year Daily Chart of BP plc



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

just because they're getting through a very purple patch and all is going well. And we also look at a discounted cash flow metric calculated from projecting corporate cash flows over quite a long time frame. We then look at a third factor. We try to buy companies when sentiment is improving, and we have a very simple metric. We look at analysts' estimates, and we look at whether they've been increasing over the last one and three months. And if they have, we say, "People think the company is performing better," and that will be our metric to indicate that the sentiment may be improving. Lastly, we have a simple technical score. We like companies where there is price momentum against their peer group. It slightly protects us against having missed something not captured by the other metrics. If the price is still inexorably going down, maybe it's not a good thing to invest without further investigation. So we like the price to be moving up a little bit.



So going back to your asking about selling, given that we do this screen every week, obviously not only are we using it to look for companies that we don't own, but we can measure all the companies we do actually own. So the companies that score badly on our screen, we will at least look at as again candidates for sale. Very often there's a good reason why they don't score well, and I also want to emphasize at this stage, we use this screen not because we are a believer in black-box decision making. It's just we think it gives a little bit of edge of where we then put our efforts into old-fashioned stock analysis. The actual thing that drives us to buy or sell is trying to understand the company and the business' strengths and weaknesses. What are they spending their capital expenditure on? Do you think it's good? What are their energy assets? Are they good ones? What is the management like? Are they good or are they bad? So there you go.

1-Year Daily Chart of Royal Dutch Shell plc



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

driven. We like the numbers to work. We devote a lot of time trying to get under the skin of these companies and of the industry and the trends that are affecting it.

**TWST: If you are an investor who wants to start putting money into energy right now, what are the risk factors that you should be sure that you understand? And how do you manage those risk factors?**

**Mr. Guinness:** The riskiest place to invest in the energy universe is in exploration companies, and we do very little of that. We have a big bias toward investing in companies that have got production, have got decent oil and gas reserves, as well as those service companies that are big solid businesses making profits and so on. So when you look at our portfolio, you will find that the vast majority of the companies we own are established businesses just now often on a price/earnings multiple of below 10. So you get with us a solid body of companies that you are investing in.

We watch out for excessive leverage. We look to buy companies with the right amount of indebtedness. I think we can now speak with increased confidence about this. The one thing that we found that was really troublesome in the last downturn in 2008 was companies that had too significant an amount of debt got really punished. We will nonetheless buy companies that have got debt, but we've just got to be careful it's not too much. Last time around, when markets were falling off a cliff, just everything we owned that was significantly borrowed came under the spotlight. We sold one company because it was too borrowed. In fact, it turned out we were overcautious. In fact, none of the companies that we have invested in — over the last 12 years that I've been

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I think I should, however, mention another thing. The bigger the company, the less importance we attach to management. Many of our companies are very large. In fact, we think that meeting with management can often be a distraction, and you can get influenced by completely superficial things like whether the guys are impressive or not. You can meet an oil energy executive who is very charismatic and invest in the company not factoring in that everyone else thinks he is impressive, and as a result the stock has become overvalued in stock market terms. And that has happened to me — one of many lessons I've learned through bitter experience. However, the smaller the company, the more important it is to meet the management, but again not necessarily to evaluate them. That's best done by reputation, by getting other people's views on them. But it is useful to meet them for information. We are very numbers

doing it — has got into terminal problems because of financial issues. We've successfully avoided those, though not without sleepless nights.

What other risks should you be aware of? You should be aware of the fact that oil and gas prices are very volatile, and the man who tells you that he knows that the oil price is going to be this or that — is going to go up or going to go down tomorrow — is a liar and he probably is a thief as well. We can't protect you from that. You've got to take some risk. It is our view that the medium-term price is forecastable. So if we get a selloff in energy prices because of another rerun of 2008, 2009, it likely won't be as bad this time. OPEC — and Russia, to a lesser extent — will take steps to rein in their production and be a little bit slow, but they will eventually get there and in nine months suddenly everyone works out.

Demand has gone down by 4 million barrels a day, but supply has now been cut by 6 million barrels a day. And actually things are tighter than they were before, and the price steadies, bottoms, begins to recover, and then jumps up quite nicely and that's what happened last time.

Whilst there is a risk that you have some sleepless nights, my view is that looking forward, you can always stick with your investments because the strong likelihood is that if energy prices tumble, they will recover because the oil price will recover. The same general applies to gas prices, although the different story in that there is no OPEC to sort out the gas price, but instead you've got the protection that the gas price is right on its back at the moment. You can't say it won't fall further. You never can say that, but if it does, it will recover before too long because

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when it falls too far, people just stop drilling for it and the supply of gas dries up and the market tightens very quickly. So much gas is now produced in the first two years after you drill a well, because that's the nature of the wells they are now drilling. Fewer wells drilled will quickly balance the market, not immediately but within nine to 15 months.

As you may have gathered, we are basically slightly old-fashioned, long-only investors. We put our money on the table, and we sit with it and we tend to stick with it when things are going against us because on the whole we believe in our judgment. So investors who invest with us must understand that. We think that in the long run this approach works. If you look at the performance of my funds over the long run, they've done pretty well, and one reason we find this works is because one of the problems if you try to actively manage your downside risk, you are often too cautious when the upturn comes, and you get whipsawed. So while energy equity investing has risk, I would like to think that the energy equity complex is lower risk than many other parts of the market. If you look at the S&P sectors, the energy stocks are on the lowest p/e of any sector on both last year's earnings and this year's. You might say this year's earnings have been somewhat inflated by the stronger oil price, but that's not true of last year's. And in my view, the downside here is much less than for any of the sectors that are involved with slowing down of consumer spending in general or the banking sector.

If it's of any comfort, I've got a reasonable amount of my own money in the energy sector. I put my money where my mouth is. As a matter of fact, I broadly only invest in four areas. I invest in my house. I invest in cash, and that's for a rainy day, and I invest in energy equities and Asian equities. And that's because I believe in them.

When you initially asked me about energy investing, I should have started with giving some specific reasons, bearing in mind the particular investment climate we're now facing. I didn't step back and talk to you about the two or three big picture things and I will remedy that now. I'm a believer in the Jim Rogers commodity and broad equity market cycles that oppose each other. He and I believe you have strong broad markets in equities and commodities alternating. Underlying this are long 15- to 20-year cycles in supply, which move slowly from excess to shortage and back. So we saw from 1980 to 2000 very strong noncommodity-related equity markets, and we're now in the middle of a 15- or 17-year period of noncommodity equity consolidation. Noncommodity equities got overvalued. Meanwhile, commodities and commodity

equities had a pretty raw deal from 1980 on through to 1998. That was a pretty painful commodity bear market — certainly for oil. Now we're in an 18-year commodity bull market, and we're probably two-thirds of the way through it. At the moment, prices are still not high enough to generate excess supply while demand grows steadily. And energy supply has an added problem that readily accessible cheap energy supplies are getting harder and harder to find.

In regards to energy demand, yes it is true that the developed economies of the world are now able to grow and become more efficient, keep energy demand fairly stable. But emerging economy energy demand is another matter. Basically speaking, the developed economies of the world are growing their economies by 2% to 3% a year, and their energy consumption is rising by 1% to 2% a year, so about 1% less. Within that, oil is actually rising even more slowly. Gas consumption is generally keeping pace with economic activity. So that's the developed world. In the developing world, you just cannot damp down the demand for energy. Even in 2008, 2009, the demand from the developing world continued to rise. And it's really this year producing all the growth, the 1.5 million barrels of extra oil the world is consuming is all being consumed in the developing world and that is going to go on for at least 20 to 30 years.

The reason it's going to go on is that countries like China, about eight years ago, reached the foothills of a level of GDP per capita that enabled increasingly serious numbers of people to be able to own their own motorized transport, and that typically takes the form of a motor car. And luckily for us, the Chinese are buying small motor cars, and they are more efficient motor cars than American cars, but still they are buying them. They are buying them in big numbers, and the Chinese

motor car vehicle fleet is now rising at 12 million cars a year, which by the way is the same as the number that's being produced in America at the moment. And this is up from only 4 million cars a year seven years ago, and it's going to go on growing. The Chinese car fleet — for example, which is now at about 90 million cars — will catch up and overtake America's vehicle fleet, which is about 255 million. Sometime around 2020 we think they both will be around 300 million vehicles. That was just a simple example. Another dimension is that China hasn't yet even started importing liquefied natural gas. And they have to reduce the amount of coal they consume. Their whole energy economy is unbalanced. It's very bizarre. China consumes a tenth of the natural gas that America does. It consumes about 40% of the oil that America does, but it consumes twice the amount of coal. It's amazing. America, I think, consumes a billion tons a year. China consumes 2 billion. In

summary, on your question about risk, the short-term risk is volatility, but this is hugely mitigated in the medium term by the continuing cheapness of energy equities, and these strong underlying forces inexorably driving energy prices up.

**TWST: Thank you. (MES)**

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While the funds are no-load, management fees and other expenses still apply.

Price to earnings ratio (P/E) is a common tool for comparing the prices of different common stocks and is calculated by dividing the current market price of a stock by the earnings per share.

Contango is when the futures price is above the expected future spot price.

EBITDA to sales ratio is a financial metric used to assess a company's profitability by comparing its revenue with earnings. More specifically, since EBITDA is derived from revenue, this metric would indicate the percentage of a company is remaining after operating expenses.

Discounted Cash Flow (DCF) is a valuation method used to estimate the attractiveness of an investment opportunity. DCF uses future free cash flow projections and discounts them to arrive at a present value.

**Diversification does not assure a profit or protect against a loss in a declining market.**

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**Top Holdings - as of  
6/30/12**

	<b>(%)</b>
<b>1</b> Valero Energy Corp	3.90%
<b>2</b> BP PLC	3.69%
<b>3</b> Chevron Corp.	3.65%
<b>4</b> Eni SpA	3.60%
<b>5</b> Royal Dutch Shell PLC	3.53%
<b>6</b> Apache Corp.	3.51%
<b>7</b> Total SA	3.50%
<b>8</b> OMV AG	3.45%
<b>9</b> Marathon Oil Corp.	3.41%
<b>10</b> Nexen Inc.	3.39%