Letter to Investors - Tarpon Folio

Part One: Eighty-four Days Without Fish

"Price is a crazy and incalculable thing, while value is an intrinsic and indestructible thing."

- *G.K. Chesterton*

Dear Investors,

This is the first of four sections of my update to you on the Tarpon Folio.

The entire report is lengthy. I wanted to explain this year's performance, the market's volatility and our new focus on a single sector. And some things are impossible to generalize.

I am above all just trying to think independently. If I were to compress this entire update into a single message for Twitter, it would be this:

> *I refuse to let other people do our thinking for us. Also, the decline curve never sleeps.*

The 'No Jargon' Version of What Happened

We are down in Tarpon because, in short, I have been early on oil stocks.

I clearly underestimated just how pessimistic the consensus view on oil prices could become. I also believed the oil market would be much more forward-looking than it has been.

As a result, my brilliant plan to capitalize on the vicious selloff in oil and gas companies earlier this year did not survive first contact with the enemy. More specifically, after some success in the winter and spring, we were caught long and wrong as oil fell from $61 a barrel in late June to $38 in late August – a 38% decline in oil prices in just two months.

And that collapse made the last few months in Tarpon feel like some kind of trial out of the Old Testament.

The Wonky Version of What Happened

Tarpon is down due to a combination of (1) poor timing on my part in terms of oil prices, (2) views I hold that differ dramatically from consensus, and (3) an investment process that, in order to maximize our odds of significant outperformance in the future, has led to significant short-term volatility.

In addition, I was too slow to update my analytical approach to investing in certain exploration and production companies ("E&Ps") in the following two ways, specifically:

1. I had been overweighting the ability of an E&P to manage its margins, and underweighting raw geology. Higher oil prices, as it turns out, can obscure the importance of owning really good rocks.

All operators are limited in their ability to generate cash by things that are entirely out of their daily operational control - including oil prices, royalty rates, and lifting costs. It is not enough for low-cost production to be considered a moat if that advantage is based on efficiencies gained in daily operations. Those will eventually be copied. What cannot be copied, however, is the sustainable advantage that comes specifically from the most material thing a management team can control - where they choose to drill.

Geology is destiny. And the top priority here, really, should be to have both - great managers and great rocks – providing we can buy that combination at an attractive enough discount.

2. This year's oil price collapse is forcing the industry to move from the previous "land-grab and maintenance drilling" phase to a new "rationalization of acreage and more deliberately exploit reserves" stage. In other words, several of the things that made some companies highly attractive to me in January no longer seemed nearly as important by August.

The result of the errors above were losses on several oil companies we have since sold in order to high-grade our own portfolio of energy shares - with more trading in Tarpon than usual in-between.

What I Am Doing About It

In spite of terrible market sentiment and the unforced errors above, I have continued to buy more shares of the best, most undervalued energy companies I can find. I did not take that decision lightly. I realized it would come with increased volatility, not to mention more than a few raised eyebrows on the subjects of concentration, diversification, and, well, my sanity. In the end, however, every bit of logic I had compelled me to keep grinding it out.

To be clear - I realize that watching big swings in the paper value of your holdings can be unsettling. I also understand at a visceral level that our recent results have provided little validation for your belief in my investment process. But please hang in there, anyway. The price-to-fair-value of Tarpon, our potential to compound returns at a high rate and - most importantly - the odds we have on our side right now are each the most favorable they have been since late 2008.

And despite our lousy results this year to date, we don't need any heroics to recover. We just need to sit still and wait – specifically, for the global decline curve to kick in. More on this later.

In the meantime, I expect the demand for oil to continue to respond to lower prices - as it always does. I expect supply to respond to lower prices, too, as it always does. This time is not different, just unusual. In the end it is just another oil price cycle, and we are in the trough.

Calling Our Shot

I believe you are paying me to run Tarpon in as intellectually honest a way as possible. In good times and bad, I happen to really believe in this philosophy called value investing. And under that framework, returns are not necessarily optimized for comfort. They are optimized for long-term compounding.

To acknowledge the obvious - value investing does not work all the time. It's been a frustrating stretch for performance, but although it is hard to see right now, it is actually an excellent one for establishing higher future returns. My timing of late has, with the benefit of hindsight, been horrible. But I also believe that before too long, that will not matter, either.

My own assessments of the values of the companies in Tarpon to date this year have not mattered. But they will, and likely beginning fairly soon. And as frustrating as the past few months may have been, it may also have been our very best period for establishing a new foundation for long-term compounding.

So, in summary, I am shaking it off and calling our shot. We have slowly loaded up, and now I am done. It has been volatile, it is has been frustrating, and it is unpleasant to report poor results. But the only way out is through, and it will eventually be worth it.

The Short Version of This Update

The popular consensus is that the oil market is grossly oversupplied, due to Saudi Arabia's determination to retain market share at the expense of U.S. tight oil producers – a relatively new breed of oil companies drilling in shale, sandstone, and carbonate rock. In this consensus view, the market will remain oversupplied until significant amounts of current production are reduced - a potentially long, painful process.

My view is different. I believe there are fundamental industry trends being ignored that, unless oil prices rise fairly soon, mean the oil market is at real risk of sleepwalking into a supply shock in 2016. In the meantime, the price of oil is unsustainably low and should self-correct fairly soon.

In the update that follows I detail the reasons why I differ from the consensus. The short version is this:

I believe a significant and sustained rise in oil prices is inevitable much sooner than consensus. Massive cutbacks to drilling programs and natural decline rates across the world's oilfields may make OPEC – already operating at close to max production – and the U.S. shale oil industry – with more than half of its fleet stacked – unable to increase production enough to control the pace of an increase in oil prices as demand begins to exceed supply.

Oh, and also:

Is it just me, or does the Middle East right now look like a Tom Clancy novel that ends in massive sectarian war?

There is currently a very low level of spare production capacity available across the industry, leaving the market particularly vulnerable to any material supply shocks…say, the kind that could be caused by an attack on certain Middle East oil facilities.

And, um, nobody has told the oil market.

I believe today's extreme pessimism over oil prices is unwarranted.

Contrary to popular opinion, the global demand for oil is actually robust and growing. Global oil demand is actually 2 million barrels of oil per day (bopd) and growing so far in 2015 - double the rate predicted at beginning of the year. There also appears to be a reasonable probability that in 2016, the amount of oil produced around the globe will fall like Hemingway described going bankrupt:

"In two ways. Gradually, then suddenly."

I am basing this opinion primarily on basic math, economics, and a little armchair petroleum engineering. It is not exclusively my opinion – there are a few others who share it, too. But it is nonetheless being crowded out by a particularly ruthless kind of trading on Wall Street, and an echo chamber of breathless and irrational voices around it. Consider this update my small attempt to rectify that.

In the pages that follow I will further discuss a number of wonky issues, including compound annual decline rates, marginal costs, and cuts to capital expenditures. I believe that any investment thesis related to oil companies these days has to be built on those sorts of things, really, or else the potential for confirmation bias can be too high.

As a result of the recent collapse in oil prices, I believe the shares of certain U.S. oil exploration and production companies represent very appealing opportunities to compound our capital at a high rate of return over the next few years. The shares of the companies we now own in Tarpon have been extremely volatile. But that same volatility appears to have driven out the vast majority of institutional investors, who because of clients far less patient than you, are doing their best to avoid the sector entirely. This has temporarily left us with a large, exploitable advantage over some of the biggest investors in the world.

I believe the odds we have on our side right now are the most favorable I have seen in any area of the stock market since late 2008. As a result, Tarpon is now entirely focused on this opportunity. I have deliberately chosen to concentrate our efforts and capital here. We are, effectively, all-in on U.S. energy companies, and this is somewhat of an unexpected and dramatic shift in our holdings.

I'm hoping this letter in its entirety explains why.

Questions From the Mailbag

Here are some answers to questions I've received via email the past few months.

When Will Things Turn Around?

By far the most frequent question I have gotten this year is this one:

"When is Tarpon gonna turn around, moron?"

First of all - take it easy, Mom. Other people are going to read this.

Second – In Part Four of this letter I will discuss the concept of compound annual decline rates in detail. This more than anything else will underscore why I am confident we will see things turn around significantly at some point relatively soon.

When it comes to predicting an immediate turn in Tarpon, though…first, I have three qualifiers.

First - Tarpon's fate is tied to the price of oil, and more specifically, WTI, or West Texas Intermediate crude oil. In the short-term, the price of oil is theoretically determined by what happens in both the physical and financial oil markets. In the long-term, the price of oil is determined by the marginal cost barrel, as per my letter earlier this year.

And this decline is getting really long in the tooth, so that "in the long-term" bit would start to seem more and more relevant on the financial side of the market fairly soon. More on the historic duration of this current collapse a bit later. In the meantime, we're all essentially depending on irrational traders to rationally agree with each other that things have finally really just gotten way too crazy in the oil market. I'm amazed we're not there yet, frankly. But here we are.

Second – I'm of the opinion that this summer's drop in Tarpon is not going to matter in a few years.

Now, I don't mean to downplay this year's volatility. At all. Shoot, I lost fifteen pounds, turned four shades paler and my hair turned shock-white. Imagine an Anderson Cooper wig on a plucked turkey with leukemia. It was a long summer, knowwhatImean?

Nonetheless, what I'm saying is that the shares we own in Tarpon right now are so significantly undervalued that their expected returns are attractive enough to me that I am not too concerned about our current paper losses. Yes, obviously, I'd have rather fast-forwarded through all that, too, but when it comes to oil prices in the medium-term the world is facing structurally rising demand, increasing rates of oil field decline, and now a very large, price-driven capex deficit. And the longer it takes for prices to rise in the short-term, the faster or higher they will eventually rise in the long-term.

The third reason that question makes me a bit uncomfortable is that predicting the short-term price of oil is a task at which I have recently demonstrated complete and utter incompetence.

Calling the bottom of the current downturn has been difficult for a number of reasons, but foremost among them is that horizontal drilling in U.S. tight oil fields is changing the established market order as I type.

At the moment, Wall Street is also hyper-focused on anything and everything that could affect the price of oil on a day-to-day basis. I try to stay focused on our companies and those external factors that will affect actual oil production and demand in the industry, believing the price response will take care of itself.

Said another way – the market thinks the only thing that matters is whether this morning's news about oil prices was better or worse than yesterday's. And all that news, regardless of true importance, is seen as critical. I'm saying what really matters is the difference between where oil is priced right now versus what it should rationally be worth, regardless of temporary factors.

So with those qualifiers in mind – and to the extent that the short-term price of global oil can be successfully forecast based on rational thought and logic and exclusively U.S. data (bwaahaha!), I would answer like this:

Oil production in the U.S. is on pace to decline by the end of this year by approximately 600,000 barrels of oil per day (bopd), down from approximately 9.6 million barrels bopd at the peak this past April. This pace is significant, though it has recently been obscured by temporary oil storage increases due to seasonal refinery maintenance, which now appear to have peaked.

Last week was the first back-to-back decline in crude oil storage in the U.S. since May. More than 1.4 million bopd is still offline during routine maintenance as refineries tune things up after a very busy summer driving season. Refinery processing runs should rise by up to 900,000 barrels per day during November and December, if past history is any guide.

All of which means the actual decline in U.S. oil production numbers should begin to become that much more obvious to even the most daft of headline writers. And we should soon start to hear more and more about large consecutive draws on crude oil stocks in the U.S. as we head into the end of 2015.

In early October, we actually saw some significant though fleeting gains in Tarpon based on similar large weekly storage decline numbers right before refinery maintenance season began. This may bode well for Tarpon as we head into 2016.

So, in a perfectly rational world, the long-awaited upward turn in oil prices should begin to become obvious starting, well…now.

That said, one of my own frustrations of late is that, in theory, markets and stock prices should both be forward-looking. We are clearly in a market driven less by theory and logic, however, and much more by the sentiments of traders. Should that sentiment finally shift away from the concerns about oversupply that have been so prevalent for so much of the year, then the worst is behind us.

So my inability to time the bottom of the oil market has absolutely caused us all a lot of angst this year. Volatility is different than risk, though. And in the end, capitalizing on beaten up stocks after they've been sold off indiscriminately for a long period of time is going to be very good for us. But I also get that this is hard to see at the moment.

Risk is a topic I will discuss more in the second part of this series. So standby for more thoughts there very soon.

I've also gotten a number of questions lately that, although each was phrased a bit differently, were about similar subjects.

Here are some quick thoughts on those topics.

On the strength of the dollar:

While the dollar and oil prices are clearly and strongly inversely correlated of late, it's just that - a correlation - and not causal, and that the relationship will likely weaken if/when the Fed raises rates.

On future oil production from Iran:

Given the drop-off in global production I expect to see by late 2016 – when Iran purports it will begin to re-market an incremental 400,000 bopd of somewhat questionable quality crude using possibly decrepit facilities – the world will likely need that new crude to meet demand, anyway. Standby for the section on decline rates a bit later in this series.

More broadly, I am skeptical that Iran has the technology and capital to increase its production by more than 400,000 bopd by the end of 2016 - despite its own propaganda and the uncritical parroting of it by the financial media. Also, as it turns out, that "oil" Iran has in storage is not actually oil – it is low quality condensate. Facts, meh.

On U.S. rig counts:

Rig counts just don't matter much right now in the face of high-grading and wellbore design, especially in this phase of the cycle. Or, at least they don't matter much to me, a fundamental long-term investor.

They may matter, however, to traders and their algorithms. Specifically, rig counts may be important when it comes to gaming short-term price movements. To traders, the importance of rig counts of late seems unrelated to actual U.S. oil production. Of greater significance seems to be whether or not, say, changes in the rig count numbers released last Friday will be significant enough to cause the Energy Information Administration to tweak its weekly reporting model – which will push oil prices around next Wednesday.

But this kind of lunacy should not be confused with investing.

On "weakening demand for oil from China":

This has gotta be one of the most tired myths of 2015.

First, in Q3 of 2015, demand for oil in China was up 6.9% year over year.

Here, quickly, is the demand for oil from China:

2012: 9.7 mm bopd
2013: 10.1
2014: 10.5
  1Q15: 10.4
  2Q15: 11.0
  3Q15: 10.9
2015E: 10.8 (OPEC est.)
2016E: 11.2 (OPEC est.)

This is strong demand and good growth. What are we talking about here?

Demand for oil in China has been and should continue to be quite strong, due to (a) growing consumer demand, (b) efforts to fill the country's SPR or Strategic Petroleum Reserve, and (c) the country's transition to a mass automobile culture.

China economic data has both bullish (consumer) and bearish (industrial) data points. It's a cherry-picker's dream. But both data sets should be kept distinct in your mind from the Chinese stock markets, which are not at all markets in the traditional sense due to heavy government involvement. Those stock markets seem to run on a series of liquidity-driven bubbles. They have little relationship to the fundamentals of the real economy, which, incidentally, is still growing twice as fast as our own. So if you are concerned about oil demand in China, please prepare to explain to me why you are not concerned about oil demand in the U.S. first.

The U.S. stock market's recent concerns about China perplex me. The relationship between the two countries economics is small. Specifically, only about 7% of U.S. exports go to China, and exports only account for 13% of our economy, anyway…which means our exports to China represent less than 1% of our GDP. Big U.S. companies earn less than 2% of their total profits there, and U.S. banks have less than 1% of total U.S. banking systems assets there.

China's economy and stock market may have challenges, but its demand for crude oil, gasoline and refined products has never been higher. And I do believe it's entirely plausible to be a bit pessimistic about Chinese economic growth in the near-term without being a pessimist about oil demand from China.

I believe that's all I need to say about this. At least for now. There is more on China in the fourth part of this update.

On Saudi keeping production high for a long time:

First, several weeks ago Saudi Aramco actually announced a 300k bopd reduction in production. So there's that.

Otherwise, all countries in the Middle East, including Saudi, are currently producing near maximum levels. According to IEA and others, this has left very little spare production capacity remaining in the region. This represents a different kind of risk than implied in the original question, though, so I'll save that for a bit later.

Saudi can't pump high forever because, in short, to do so would mean they run the serious risk of permanently damaging their oil fields. The oilfields in Saudi are made of carbonate rocks, and one of the dangers associated with producing at maximum levels from carbonate reservoirs is that you start producing larger amounts of water – and the science around carbonate reservoirs suggests that once you start producing larger amounts of water, the reservoir will forever produce larger amounts of water - even at reduced production levels.

Which means an already extremely daunting engineering challenge – coaxing oil out of the ground – becomes significantly more difficult, not to mention expensive. Wells decline and deplete faster, efficiencies worsen dramatically, and corrosion can become a very serious problem. Saltwater, as you can probably imagine, can be lethal to oilfield equipment.

On the high level of short-selling in the sector:

Here was the typical short case against U.S. E&P companies I heard this summer:

"The equity of *[insert name of shale oil company here]* is overvalued. They're actually a really bad business because *[steep decline rates, no growth in reserves, have debt, etc.]* and the assets of these companies are, like, constantly depleting themselves! Plus – and we checked on this - it takes a lot of money to drill wells! Their financial statements also show *[take your pick among many obnoxious things in any E&P's financials]* and their managements always talk about *[things that good management teams don't talk that much about]* – and then the Wall Street analysts always do this crazy thing [*that no serious E&P investor would do*]. Plus, oil looks like it could stay at $ *[some completely unsustainable level]* forever, guys. So based on our *[very opaque]* analysis, the company's equity is really only worth [*some ridiculous percentage]* of the current share price. Got all that, plebes?"

And here was my inner monologue after the fifth time I'd heard that thesis:

"Keep the camera rolling. Let's pick things up using that same logic. Because it sure looks like if all that were true, then whoo-boy, the equity of every one of these other unconventional oil companies is just about worthless too, then, eh? And man, if institutional investors cannot get decent returns on that equity capital, forget it! Those drillers will never be able to raise another dime. What a sweet short! Kiss that 5 million bopd of production goodbye. They're just gonna twist in the wind. And then imagine what will happen once the decline curve starts just wreaking havoc on that remaining production. It'll be bedlam! I mean, eventually, the carnage would get so bad that…um, well, it would get so bad that…that oil prices will have to go back up. Which would really boost the value of all that equity. Wait, what were you saying again?"

Or, less dramatically, the common E&P short-seller logic appears to be…

Capital-intensive cyclical >> Equity worth bupkus >> Same issues affect all peers >> Sector is starved of capital >> No growth >> Decline curve crushes production even more >> Global oil out of balance >> Oil prices rise >> Equity worth a lot!

This short thesis is not a serious argument. It's Wall Street demagoguery.

To be clear, some E&Ps will not make it out of this cycle – at least not with their current equity base. But not nearly as many will fail as the shorts would like you to believe, either.

And the irony is that every one of those guys, if given the chance, would fall all over themselves to make an equity investment in an oil company on terms like this:

No leverage, no bloated corporate structure, no dry holes, and your equity capital goes to work right at the wellhead – giving you excellent economics on something even as piddly as a little 20% internal-rate-of-return well.

Shoot, you'd have pension funds lining up all day long to fund that opportunity - for just half of those returns. Those same short-selling hedge funds would do it in a heartbeat, too.

Only afterwards, they would charge you 2 & 20.

Last three questions.

Will the Fed raise interest rates 25 basis points in December?

Does it matter?

Is the U.S. about to go into recession?

No.

Can I feed these seagulls?

Get out.

I'll publish more Q&A on the blog soon. Fire away with new questions in the meantime.

Next, let's talk about risk. Part Two is coming up.