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Investment Management

# Written Q&A

As part of the 2017 IIM Annual Investor Meeting
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*By Cale Smith, Managing Partner*

**Question 1: How do you extrapolate the U.S. draw out into the global draw? Seems like this is the million dollar question…**

Yes, big question, and as usual in the oil market, there is always going to be some ambiguity in the macro data that you just have to mess around with enough to get reasonably comfortable, anyway.

The short version is at this point in the cycle I don't think you don't need to formally extrapolate intra-country nor try to track draws on a country-by-country basis. It takes too much effort and is subject to too much uncertainty. But if you track the rates at which inventories are dropping per month in the U.S. (from EIA numbers) versus in the OECD (ex-U.S.) countries (thru IEA numbers or even OPEC headlines, like last week), you can get a good sense of where flows stand in the world. And then if you apply recent drainage rates to good U.S. and global inventory numbers, you can sort of draw the dotted line to where each should cross the upper bands of their respective 5-year-average numbers…and then that will give you a good sense of when and how the deficit in flows will soon be impacting global inventory stocks, too.

My point is don't waste time tracking down data that is not high quality. Just use what you can to draw solid conclusions, even if it's not as precise, and then try to verify those conclusions with folks who have the time and expertise to track inventories at the country level. We pay for research from Energy Aspects, for instance, who are solid on non-OPEC inventories. So, do the work to figure out the levers and understand the sensitivities involved, but don't kid yourself into believing you have the inventory situation in Equatorial Guinea all figured out, either. We pay experts for that.

Hope that helps. If that doesn't make sense, ping me and I'll try again.

**Question 2: Are there any other companies or sectors in the market that look like either interesting or a better risk-reward?**

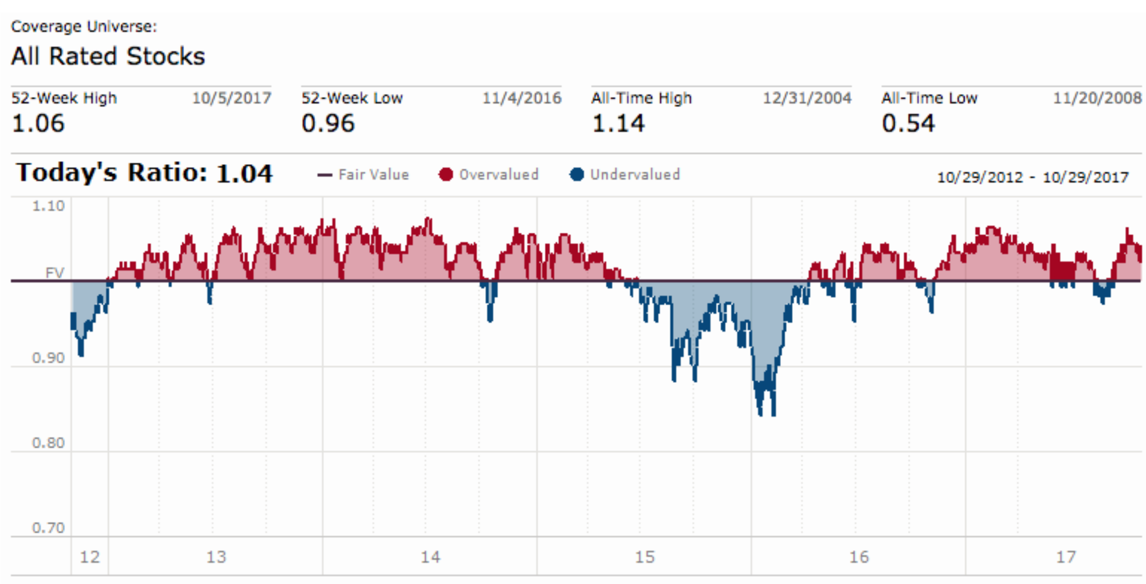
Two questions there, really. Will take the second part first: no, there is nothing else out there I see with a better risk/reward than U.S. E&Ps right now.

The only reason we are as focused as we are in Tarpon on oil companies right now is strictly opportunism. We have a rare chance to earn very high rates of return and, at this point in the cycle, with low odds of permanently impairing capital. In other words - we're here because we want to be, not because we have to be. We are going to milk this oil recovery for all it's worth, and then move on to other pastures at some point.  But not yet.  We have plenty of compounding to go. So, I try to remain pretty objective about it all, and would absolutely consider other non-energy related companies if they were as cheap, but they aren't, so I don't.

First part of that question – are there any other areas that look interesting?

You may not like this answer, but here it goes.

It is hard to get interested in 99% of everything else right now because valuations seem relatively high across the board. Here is a graph from Morningstar putting the overvaluation of today's U.S. market compared to the last 5 years into some context (look to the far right).




But there is one area of the market that seems very cheap.  And that is commodity companies. Here is a chart that shows you just how cheap commodities are in general right now over a broad period of time.

**Chart 1: 100 Years of Commodity Valuation**


*(1) Goldman Sachs Commodity Index to 1970. Goehring & Rozencwajg Commodity Index pre-1970.*
*Source: Bloomberg, Goehring & Rozencwajg Models.*

So, in theory, commodity companies are an area that are interesting to explore right now…but not without some reservations, too. (Like the quality of some of those businesses, plus the cyclicality, which we've all probably had enough of). Hold that thought and let's just see where oil goes first.

**Question 3: Tarpon is down big this year. Are you getting discouraged?**

I'm doing fine, thanks. I don't enjoy being down like we are, but I can handle it. That's the job.

Look, presuming that the oil market is efficient, and that being right or wrong in the short-term is determined by oil prices is, I think, a pretty naïve view of this market. The oil market is hard, but for a number of reasons, its also hugely inefficient. Which means we can make a lot of money. So I try to stay focused on the things I can control…and I am very excited about valuations. We're buying shares of ENSCO (ESV) a few months ago at 0.19x book value. It is hard to articulate how significant this could be for us over the next few years.

So, I appreciate the concern, but I'm good. I worry more about your guys' reactions to all this volatility than anything else. I can handle it, because I spend every day thinking about it all and re-checking everything…but you all don't have the same conviction because you have, like, real lives. So keep asking questions. And the fact that not too many others seem to agree with us about our companies right now is inconvenient, but okay. They'll agree with us later.

**Question 4: What effect have the hurricanes had on our investments in oil?**

Hurricanes Harvey and Nate temporarily tweaked U.S. oil inventory numbers down there on the Gulf Coast. To an extent, they have obscured these big inventory drawdowns we have been seeing. But that's just short-term stuff. Our companies with production in the Eagle Ford area down there have no lasting issues due to the storms, so I have no longer-term concerns, either.

And actually, Harvey in particular could prove to be supportive of oil prices in an indirect way. I mentioned this in one of the earlier slides about labor availability. Because of all the reconstruction that is needed around Houston, it could in theory be even harder to fill jobs on drilling and completion crews in Texas. Too early to tell yet. But would you rather be a roughneck in the Eagle Ford, with you and your family's livelihood subject to all the volatility of the oil market…or would you rather steadily build homes in Houston for the next ten years? Probably a lot of overlap in that labor pool.

So if the roughnecks go build houses, then shale companies can't drill as much, supply falls further behind demand, and the price of oil climbs higher - over time. At least until salaries go up in the oil patch. So not an obstacle so much as a speed bump. We will see how all that shakes out, but I have no concerns about those hurricanes at this point, and Harvey be a small positive to it in one respect.

And down here in the Keys we can no longer talk about hurricanes this year.

**Question 5: How long will we own these stocks?**

Another version of this same question was, basically, "It's been two years…how long are we gonna do this, man?"

The first rule of compounding is **not to interrupt it unnecessarily.**

My plan is to milk everything we can out of our existing positions and then one day get back to much more boring companies.

I want to maximize the benefits of compounding we will see…and to do that, we should own these companies to the peak (price spike) in the upcoming cycle. I get that answer may also be kind of unsatisfying compared to saying, “I think it we will own them for six months, or three years,” but that’s how I think about it.

And one big advantage we have in this market is that we have no timeframe. I don’t see the point of putting artificial constraints on things in that sense.

This is still is a once in a decade opportunity, and to sell early is a huge mistake. I’m not sure people grasp the potentially life-changing aspects of compounding money at times like this. And either way, right now, the data is hugely supportive of staying put.

So…I suppose it comes down to the pain of discipline versus the pain of regret. If this whole thesis proves invalid for whatever reason, we will move on. But if it holds up, as I obviously think it will be, then we move on with, well, a lot more.

**Question 6: As your investors, we are all subject to your errors in judgment. We are very focused in oil. Is there a way to protect ourselves in the future from being this one-sided?**

In retrospect, that 82 page investor letter I wrote back in November of 2015, all about oil, was among other things my attempt to prepare you all for something that was going to be pretty different for us. And in there I talked about cognitive biases, how I tried to protect all of our money from my errors in judgment, and had a handful of other thoughts related to trying to protect us from any errors I might make.

But, yes, obviously – you’re right. All investors are susceptible to that same risk from each of their portfolio managers. That’s just part of the deal…but I hear ya, and there are two process-related things that Retz and I are considering doing here to help address that risk from your guys’ side. The first is formalizing an investment committee here, where Retz and I can be more sounding boards for each other’s portfolios, and the second is opening some private message boards where I can communicate more frequently with you all, and you can ask me more questions along the way…and try to do all that in an easier, more scalable way. Both are just ideas right now, but stay tuned. I’ve gotta get our new ops boss Maria up to speed on things here first.

On that same point about errors in judgment, more broadly…the biggest thing I wrestle with is confirmation bias, or making sure I am not just seeing only what I want to see in all this data about the oil market. There are a handful of things I try to do to stay objective, but one of the biggest is reading arguments from the oil bears. I have been contacted by one notable bear who runs a hedge fund that is short oil, for instance, and that sort of back and forth is a good thing. I feel like I can articulate the bearish argument for oil as well as anyone on that side…and yet I can still dismantle each of those points with data. So yeah, I spend time trying hard not to fool myself about all of this.

And again, at some point, this oil thesis will play out, and Tarpon will go back to being a more diversified. I look forward to the day where we own cheap, boring bank stocks and insurance companies again. I, too, am tired of the volatility in this sector…but at the same time, things like "feelings" are not a consideration in managing this portfolio – and that's because my experience is that the times you make the most money are right after the times you feel most miserable.

So we are absolutely one-sided right now, but we won't be forever, and I hope all this volatility in the meantime doesn't drive you too crazy.

**Question 7: I've read a lot of articles about oil prices being trapped in a "shale band." Big oil hedge fund managers like Andy "The Oil God" Hall have closed their funds, because they apparently are worried about it, too. What will break oil out of the shale band?**

I discussed this shale band topic in the slideshow I did under "Lower for Longer," and then even earlier in the bit about comparative inventory analysis, too. So please check those out if you haven't already, and then let me know if there is anything I missed.

Bigger picture: expecting any commodity to stay range bound forever (the "new normal") is completely irrational given the nature of commodity price cycles. They all can be range-bound for a while, sure, but that sort of thing is just not sustainable given the cyclicality of supply versus demand. And this is particularly true for oil.

In 2012, it was, "Oil will never trade below $100 again," and now it's, "Oil will never trade above $55." That is this market.

On the Andy Hall front – I don't know him, but I am almost certain that he closed down because his inventors fled, not because he really sees oil stuck down here. He appeared to own just three oil stocks (three!) that were (in my opinion) overvalued in any case. So perhaps he was a puny god.

And if we're comparing oil traders, I would submit that Pierre Andurand sees oil hitting $100 again within the next few years.

Anyway, let's just consider all that stuff about other fund managers a wash and ignore it, eh?

**Question 8: We own almost exclusively shale oil companies. According to *The Economist*, the shale industry has been burning cash [for a long time], even when oil prices were much higher. I've also seen lots of other articles [questioning the viability of these business models]. Why is shale a better way to invest in higher oil prices than crude oil futures or conventional oil companies?**

Again, please don't mistake me as an apologist for all U.S. E&Ps. There are more than a few companies in this industry that deserve to be shorted, some with extreme prejudice, and then others that are overvalued – even now, in the trough of this cycle.

So it's a mistake to paint all companies in the sector with the same brush. We're not buying the sector, we're buying specific companies, and some we own, like EP Energy, were free cash flow positive even during the first quarter of last year when oil hit $26. Others we own also suspended production at times during this downturn, specifically so they would not burn cash. So our portfolio looks significantly different than the companies that those sorts of headlines typically apply to. And I believe that particular *Economist* article references a Bloomberg study that used the top 60 U.S E&Ps by market cap…and that is not us.

Here, I think, is what *The Economist* is missing:

The shale oil industry is still young. It takes time to reach the free cash flow part of the cycle – both for the commodity and the sector.

So look at where they are in this industry's cycle, exclusive of oil prices. For 160 years, these guys were wildcatters, gambling and drilling holes in the ground. Now these guys are becoming engineers building mini-manufacturing plants. It's still early – so early that you might make the case that expectations for free cash flow *early on* should be kept in check, while these companies locked up acreage and further developed their processes and technology. And now the market is finally forcing these guys to shift from a "production growth at all costs" phase into one where internal returns and free cash flow should (more appropriately) matter.

To presume like that *Economist* article does that the worst downturn in the history of the modern oil industry isn't going to change how boardrooms allocate capital among these new, responsive companies is either silly or pretentious.

I'd also be curious to know how *The Economist* thinks Chevron justifies its $4 billion investment in the Permian.

Anyway, the reason these guys didn't see free cash flow during $100 oil is because they were heavily investing in new production. E&P is a capital-intensive business, and early on probably should be evaluated more on a project NPV basis than unrealistic, point-in-time metrics. So they didn't see much in either profits or free cash flow, but that's because they were investing heavily in future production, not because the business didn't work.

And I think it's also odd that these criticisms don't note that the outspending the guys were very public about was to increase both production rates and proven reserves. They're building assets. It'll flow through the income statement later. They're not tricking anyone or hiding anything. Which companies do you think are more transparent…tight oil companies, or banks?

Not. Even. Close.

Anyway, back to free cash flow…so, after $100, oil drops to $50 and below the last couple years. This was waaaay below the strip that existed at the time the big shale investments of 2011-2014 were made. And a good analyst wouldn't say previous projects were duds based on a price change that was not foreseen by anyone. And yes, some wells that would have had positive NPV didn't work out that way, just because the oil price crashed.

Anyway, I really don't see any of the signs of irrationality that the bears talk about. Capital has gone in and out of the industry based on oil prices since the crash. That seems rational. If this whole industry were broken, capital would have stayed away after learning its lesson. But it hasn't. Even a substantial amount of private equity capital is going into oil development.

The shale oil and gas business is a predictable business in many ways. Producers can predict the number of wells they will drill that year, estimate the cost to drill, and budget the capital spending plans surrounding it. It's a way more predictable business model than conventional production. The biggest caveat is just that you don't know what you will sell the oil and gas for. But even then, you can hedge. So the only uncertain variable in the shale business model is the uncertainty in the commodity price, and that can be mitigated. And if the oil price is upward trending, then the free cash flow can absolutely surprise.

On the question of why shale producers versus other ways to invest in this downturn…because they are better businesses, really, and represent the most value. The most hated part of the most hated, longest, deepest downturn in oil market history. So they represent the highest long-term annual compound returns coming out of this cycle.

Shale companies just have a better way to get oil out than conventional producers – largely because of the much greater productivity upfront. It's manufacturing now. They will also benefit disproportionately when oil prices increase – although not necessarily at under $50. Share prices are not linear in that sense…but I do expect them to increase on an accelerated basis the higher away from $50 we get. So their cash flows will increase the soonest and (arguably) the most compared to the conventional guys as WTI increases. Plus you've got way more transparency into everything for the small guys. And they've just got more operating leverage then their conventional peers. The boost in expected cash flows when oil is at $44 versus $54 versus $65 can make your head spin. Dramatic.

Too much risk in futures related to timing. Plus, you don't really own anything, you're just trading paper…and you can't consistently beat the algos there, anyway. Would much rather be a business owner, knowing these guys are out there working for me, even when I'm out fishing.

And then there is a whole 'nuther discussion here on why Tarpon (I feel) is a much better alternative to the oil ETFs out there. Could go thru and sort of deconstruct why I think Tarpon in particular is a much better alternative than oil-related ETFs like XOP…but just ping me later if you want to hear more there. Short version on the product ETFs is that contango roll means you can't do much there long-term.

> *[Note: I got asked to elaborate on that "Tarpon versus XOP" comment the day after I posted the first version of this Q&A. So I am now adding the following here, too, FWIW:*
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> *On the ETF issue - XOP in particular is tough for me in the relative valuation sense. The underlying E&Ps they own are popular - if that's possible these days - and on the bigger end of the cap scale, so EV/EBITDA (as a simple hack, flaws and all) just seems too elevated. And then it's most heavily weighted to basins that have their best years behind them in terms of growth...Bakken and Eagle Ford. So, in the end, won't have nearly as much torque over time as smaller, less known names, in the Permian and SCOOP/STACK. I get why it owns what it does, I suppose...need big liquid companies, and it's not a huge bullpen to pick from...but seems like that thing should be more of a bar to clear than an actual investment vehicle.*
>
> *Have more heartburn about the commodity ETFs like USO. I would pick XOP over USO just because even though they're already big and arguably rich, the E&Ps themselves can continue to eek out some grow on even a flat oil price...so you in theory, over longer time periods, don't need price rises in oil to yield price rises in the stocks. But on USO, contango roll can kill ya - when the front month futures are lower than succeeding*

*month futures and the expiration requires 'paying up' to roll the contract to a new front month. Hidden cost and then some.*

*Then again, it's not like USO is marketing itself as a long-term vehicle, either. More of an appeal to people who want exposure but don't want to buy futures...or to hedge another trade, obviously, which I get. So calling them out for being really inefficient may be a bit unfair.]*

Bigger picture - our E&Ps are generally growing and therefore cutting per unit costs, so that a flat oil price translates into a higher cash flow per share. Since I am a cash flow multiple type of guy, that's generally what I am looking for.

Over the long term, as the names go from outspend to cash neutral postures, they can continue to grow on a flat oil price - and then we don't need price rises in oil to yield price rises in their shares.

So, more levers with the equities…but mostly it's all about the long term compounding there.

**Question 9: The E&P stocks in the portfolio have dramatically under performed vs. oil prices the last six months, with some stock prices lower with oil at $50 per barrel now than when oil was $25 per barrel 18 months ago. Why is that?**

This is the "valuation lag" question.

In a word, that's probably due to 'sentiment.'

And it's not just our E&Ps, but stocks across the whole sector.

It is as negative a tone in sentiment as I have seen in the market for any sector, ever.

And really, it's not company specific as much as it is negative sentiment about oil prices more broadly, that our companies then suffer from. So the sentiment change with regard to longer-term oil prices impacts stock valuations.

Let's assume that a shale oil company was initially expected to generate a $35-$40 per barrel cash operating margin in a $55-60 per barrel WTI environment. The decrease in the longer-term price expectation for oil by $5 per barrel, all else being equal, translates into a (roughly) 12-15% reduction in expected cash margins. In addition, stock valuations are obviously impacted by the expectation that growth will now be more challenging (i.e. less free cash flow available). So that sentiment absolutely matters.

Some of that valuation lag may also related to rise of algo trading in these markets…but that is a rant for another day.

For now, yes, our valuations are historically attractive here…and they – in the laws of finance sense - cannot lag oil prices for much longer.

That some of our valuations today are even more compressed than in early 2016 may speak to the rebound in Tarpon we should soon see.

**Question 10: What effect do you believe the [expected] weakening of the dollar will have in the next year on our investments, given that several countries are now or soon will be doing away with the U.S. Dollar ties to buying selling oil?**

Two questions there.

So - oil is priced and traded in U.S. dollars. Been that way since OPEC formed in 1973.

The Chinese will soon be introducing a yuan-based (and gold-backed) crude oil futures contract, which is what I am assuming spawned this question. And that is the latest version of a number of attempts over the last few years for other countries (China, Russia, Japan) to wean themselves off the petrodollar. Three years ago it was countries with diplomatic troubles with the U.S. (i.e. Iran and Venezuela) that were leading that charge.

And the short version of my response is…these guys are stuck with the dollar for the foreseeable future. They may say that an alternative is needed, but the reality is there are no credible alternate currencies that can anywhere come close to the USD as the reserve currency of the world. Nothing else is as deep or liquid enough. The Euro was trying to get there…but then it blew up. And the yuan is not a freely traded currency and won't be be anytime soon. So this is not a risk I spend any time worrying about at the moment.

That said, it is worth keeping an eye on further out, for all the obvious reasons. China's move here, if it got any momentum, would be bullish for oil and bearish for the U.S. dollar. But let's see what happens.

More broadly, on the other question about the dollar strength/weakness in general and our companies…the correlation between the USD and oil prices has been all over the map the last few years, but historically there has been an inverse relationship. Let's see what happens as the U.S. continues to export more oil. Another one of those things that is out of our control, but worth keeping a loose eye on.

And if the question is whether or not the dollar will rise or fall versus (take your pick of other currencies)…let me introduce you here to The Queen of International Investing, Retz Reeves!

**Question 11: Why shouldn't I just own an S&P 500 Index fund instead of Tarpon?**

See that U.S. market valuation chart in Question 2.

Only 7% of the earnings of those S&P 500 companies comes from oil and gas production. And the S&P is, again, modestly overvalued here.

One of those two is trading at a high valuation, and is priced at all time highs…and the other is at a historically low valuation.

So it sure seems to me like the best way to crush the market the next few years is to own oil companies - though not just any of them. You want to be selective, or else you risk blowing one of the biggest opportunities you will see in years.

But I'm biased.