

# Investment Viewpoints

## Underweighting the energy sector in our Core and Value US Equity portfolios

June 2008

**Investment Viewpoints is designed to provide a closer look at elements that factor into UBS Global Asset Management's market and strategy views. This issue presents our perspective on one area of the US equity market—energy—as represented in our Core and Value US Equity portfolios.**

As the price of a barrel of oil breaks through \$125 and pain at the gas pump rises, energy stocks have continued their very strong performance. Within our Core and Value US Equity portfolios, despite solid stock selection within the energy sector, an underweight to the sector as a whole has been one of the largest detractors from overall performance.

Our forward-looking research continues to support this stance, as market fundamentals, in our view, do not justify

current oil prices. As the price of oil normalizes downward, we believe energy stocks in general will underperform other areas of the US market, thus rewarding our position.

**The following are the key elements that factor into our view and positioning.**

### 1. Demand growth for oil is slowing...

Everyone is talking about booming demand, especially from China. In truth, China represents only about 8% of global demand today. And while demand from China continues to grow at a fairly robust rate, overall global demand is growing only modestly. In fact, following a very strong global demand growth rate of 4% in 2004, demand growth averaged a below-trend 1.3% annual rate in 2005, 2006 and 2007.

### 2. ...While spare oil production capacity is rising.

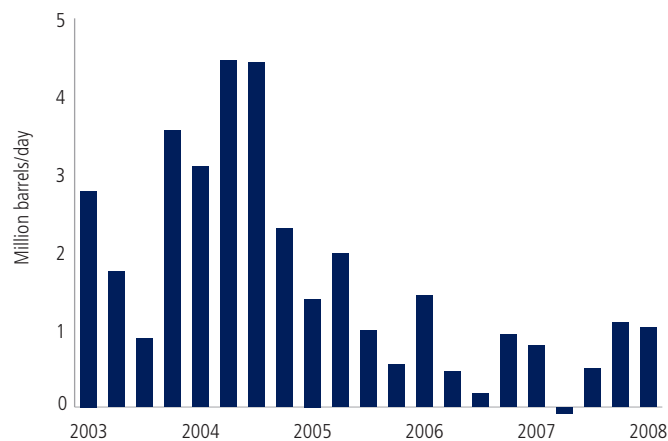
Spare production capacity, or the ability to produce oil fairly immediately to respond to a sudden rise in demand, is perhaps the most important measure of how well producers are able to supply the oil markets. While it's true that the Organization of the Petroleum Exporting Countries' ("OPEC") spare production capacity has been below normal for the past few years, it has increased in the past year due to a slowdown in demand growth, as well as a resumption of non-OPEC supply growth. We believe that spare capacity will increase to a more comfortable 4 to 5 million barrels a day over the next year, up from 3 million barrels a day in 2007, and a low of less than 2 million barrels a day from 2004 to 2005.

### 3. Speculation and commodity index allocation growth are rampant.<sup>1</sup>

Considering that supply and demand are roughly in balance, and generally moving in a direction that would support lower oil prices, why, then, do prices continue to rise?

#### Oil prices out of sync with supply/demand fundamentals

Global oil demand: Year-over-year change by quarter



Source: ISI Group.

<sup>1</sup> A commodity price index is a fixed-weight index or (weighted) average of selected commodity prices, which may be spot or futures prices. It is designed to be representative of the broad commodity asset class or a specific subset of commodities, such as energy or metals.

In recent periods, investments in passive commodity index investments have grown enormously.<sup>2</sup> This has placed continual buying pressure on crude oil prices that is inconsistent with the actual underlying demand for the commodity itself. Coupled with this, when you compare the average daily trading volume of oil price-based financial derivatives (in other words, futures contracts) to world oil demand, it appears that a growing number of investors are using leverage to speculate that the price of oil will continue to rise.<sup>3</sup>

For some time now, this has appeared to be a very good bet—one that has proven increasingly difficult to resist. But whether it's Internet stocks in the late 1990s, South Florida condominiums in 2005, or the Dutch tulip trade in the 17th century, history teaches us that speculation ultimately gives way to fair value. It is our view that when the merry-go-round stops, commodity index investments will slow, speculators will unwind their positions, and oil prices could come down quickly and dramatically.

#### 4. The fear factor.

With the conflict in the Mideast ongoing, fear over a major supply interruption has been another factor driving oil prices higher. We agree that, with less room for error in this environment, some price premium is warranted. A portion of that premium should be offset as we see OPEC spare capacity continue to grow, but this process will take time. In recognition of this, when evaluating energy-related companies, we have assumed that crude oil prices could remain higher for longer than pure supply/demand fundamentals would otherwise indicate. Nonetheless, over the long term, even after factoring in this near-term risk premium, our fundamental research continues to arrive at energy company valuations that in many cases are well below current levels.

#### 5. We invest in companies, not oil.

While the debate about the direction of oil prices draws most of the attention, the reality is that oil prices are only part of the story.

Energy stocks have performed well over the past several years because, in general, their profit margins have expanded enormously as the revenue generated from oil product sales has vastly exceeded the incremental costs associated with bringing these products to market.

Our research indicates that, over time, these profit margins will be lower than they are today, partly because we see oil prices coming down (as we've discussed above). However, we also recognize that over the next several years, the costs associated with these oil projects around the world will rise. Thus, while the supply is there, it will cost more to access that supply and distribute the oil products to end-users. We believe this combination of lower oil prices and increased costs will reduce margins for energy companies in general, and, to the extent that investors are focused on recent margin levels when setting today's energy stock prices, disappoint over time.

In the US, there are some areas of the energy sector that we view to be more attractive than others. A notable example is oil service companies that are involved in providing the logistical infrastructure for the many exploration and production projects that are in process or coming on line in the near term. These projects tend to be supported by national oil companies or large integrated energy companies that have the financial strength to continue funding such projects, regardless of the direction of oil prices over the next few years.

<sup>2</sup> Some sophisticated investors take an active approach by investing in specific commodities. But most investors will opt for a passive approach through ETFs and mutual funds that follow a commodity index.

<sup>3</sup> Financial leverage (FL) takes the form of a loan or other type of borrowing (debt), the proceeds of which are reinvested with the intent to earn a greater rate of return than the cost of the interest.

**The views expressed are as of June 16, 2008, and are those of UBS Global Asset Management. These views are subject to change at any time in response to changing circumstances in the markets, and are not intended to predict or guarantee the future performance of any individual security, asset class, the markets generally, nor are they intended to predict the future performance of any UBS Global Asset Management account, portfolio or fund. The information contained herein does not constitute a distribution, an offer to sell or the solicitation of an offer to buy securities or funds.**