Schroders
Teleconference

Schroder Global Energy Fund

Key points from a teleconference on 21 May 2008 with John Coyle, Manager of Schroder ISF Global Energy*

Macro outlook

— Most of the market's focus at the present time appears to be on the macro side.

The macro picture is quite a complex one, and as an investment house, we are extremely cautious at the moment.

Commentators point to a number of factors providing support for the high oil price, but none of these holds much water under closer scrutiny:

- It can't be put down to low inventory, because inventories are above average levels
- The latest surge in the oil price (from $110 to around $130 a barrel) has taken place against a background of dollar strengthening, which goes against the notion that investors are buying oil as a hedge against the weak dollar
- Net positions in futures and options are not much different than at other times

It does seem that hedge funds have taken off any short positions and are now naked long.

Refineries are scrambling to acquire higher quality crude, primarily for producing diesel fuel, and this is pushing up prices of WTI and Brent crude relative to 'dirtier' lower quality crude. Higher quality crude is now being priced at around a $20 greater premium (over heavy crudes) than long-term historical levels.

The relationship between marginal costs and oil prices seems to have broken down recently. Marginal costs are now around $75-80 barrel. If we assume that inflation in the industry is running at 10-15% currently, then this would add another $10 to the total cost, leaving us still well short of today's $130/barrel oil price.

Short-term technicals point to $130-135 oil, but with inventory levels already at above-average levels and more capacity to be added soon, the oil price could see around a $20 pull-back from these levels. This explains our cautious stance in the near term.

Having said this, the fundamental drivers of the oil market remain solidly intact.

Schroder ISF Global Energy

— The fund is long only, holds no physical commodities or derivatives (and has no plans to do so), and comprises between 20 and 30 of our highest-conviction stock ideas.

The fund has performed very well in both rising and falling markets. This is due to superior stock selection as well as the flexibility of the fund manager to enter and exit parts of the market quickly, as opportunities either arise or have run their course.

The portfolio is underweight large caps, especially the super-major oil companies. $100+ oil prices are not really that good for very big oil companies, because among other things, high oil prices make governments think about raising taxes on the companies.

We look to identify companies that are *benefiting* from inflation in the industry. These would include equipment and service companies with pricing power.

There are three major themes in the portfolio at present:

Offshore production – companies such as SBM Offshore and Prosafe, both of which own and operate Floating Production Storage Offtake (FPSO) vessels used in extracting oil and gas from deepwater fields

Global gas – Niko Resources and Geopark are companies benefiting from higher relative natural gas prices in Asia and Latin America respectively. Global LNG demand is expected to grow at 10% per annum, compared to the 2% per annum growth in global oil demand.

Unconventional resources – Quicksilver Resources has significant undervalued assets in Barnett Shale, where production has recently improved in economical terms

We are probably the most cautious among our peers in terms of calculating the oil price that we use in our valuations and forecasts. We estimate a long-term oil price of $60/barrel, which we concede looks rather ridiculous today. But this forces us to look for stocks of companies with very good genuine growth prospects, rather than those that simply benefit from (and are therefore reliant on) a rising oil price.

Have investors missed the boat?

— Even if we use a $60 oil price in our calculations, we think there is still substantial upside in the fund, especially over the next couple of years. Valuations look attractive, but we realise that any sharp pullback in the oil price (and we would not be surprised to see a $20 correction) would have a negative impact on sentiment and, in turn, share prices, even those that should not be overly sensitive to the oil price.

We also believe that any correction will be short term, and would look for such an opportunity to add exposure. We are currently running the fund with a 9% cash position in anticipation of a pullback.

* Schroder International Selection Fund is referred to as Schroder ISF.

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