

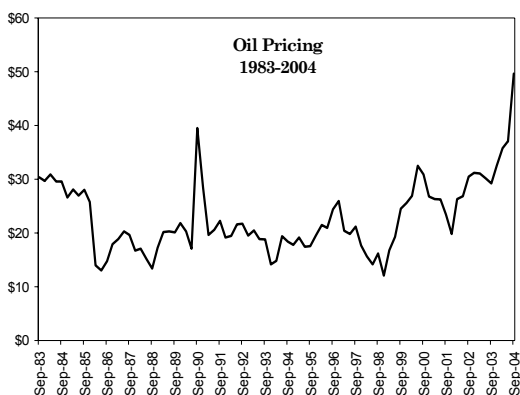
Oil Prices Blow a Gasket

By Bruce White

Oil Prices have reached \$50 per barrel, 75% higher than one year ago. Why and what does it mean to us as investors?

Oil is special:

Oil has what micro economists call “price inelasticity,” meaning increases or decreases in price result in little change in consumption. Most consumer goods and commodities other than oil are more elastic, meaning an increase in price will reduce demand until price equilibrium is reached. Oil is different. Demand is very slow to change for this strategic product. It has limited sensitivity to price, so price swings are larger and more dictated by supply changes than changes in demand.



This chart shows quarterly oil futures prices. Data source: Bloomberg

Oil has another unique economic property. As a strategic commodity, the increasing price of oil affects the

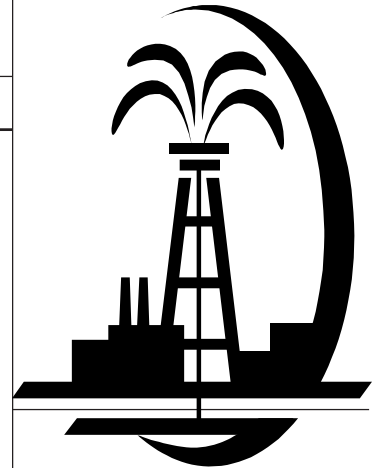
price of all other products and services. The most obvious example is the transportation sector (delivery companies, trucking and airlines). Higher fuel costs increase prices of almost everything we consume, from a loaf of bread to the clothes on our backs. The oil market is also world wide, so events 12 time zones away are immediately felt here at home.

Increased oil prices behave as a tax on the U.S. economy. This “stealth” tax slows our economy and tends to offset the inflationary function described above.

The current situation:

Generally, inventories are low in the summer with increased automobile driving, and in the winter as heating oil demand on the East coast increases. Inventories are usually higher in the spring and fall, as demand is reduced. So normal seasonal demand swings should result in higher current inventories. Instead, oil inventories in the U.S. are now at 51 days, or about 10 days less than what we would expect at this time of year.

Each day the media reports on a current event that impacts oil pricing. The following list summarizes some from recent months’ reports:



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- Hurricanes have reduced the supply coming from the Gulf of Mexico nearly 29%. This is improving slowly as rigs are repaired, tankers arrive, and ports are reopened.
- There are continued terrorist threats to disrupt Middle East oil, and not just in Iraq. Commentators have deduced that this threat has added a \$10 per barrel risk premium to the price of oil. Iraq is currently producing 1.5 million barrels per day (bpd) compared to the 2.2 million bpd it produced under the corrupt U.N. oil for food program. Iraq has the potential to produce much more, but the continued violence and disruption bring that into question.
- Russia’s threatened bankruptcy and disruption of production by the oil company Yukos, which produces 2% of the world’s oil, has been critical. The political risk in Russia is also a major deterrent to foreign investment in a country that produces 13% of the world’s oil – second only to Saudi Arabia.
- As always, there are unstable nations of the world that export critical oil supplies: e.g., Iran, Venezuela, and Indonesia. More recently, Nigerian rebels have announced an “all out war on the Nigerian state.” Royal Dutch Oil Company has withdrawn personnel from that country and labor discord threatens to shut down its production of about 2.4 million bpd.
- The amount of speculation in the oil futures market has risen and contributed to the price increase. Hedge fund managers have added to the spike using borrowed money (see accompanying article on hedge funds). The number of non-commercial buyers of oil futures has increased by two times what there were in 2002.

Over the last five years, demand has increased by 1.5% per year, while production has increased only 0.2%. There are sufficient oil reserves, just not cheaply produced oil. Drilling costs are 100% higher than they were a decade ago and developing new fields is a much higher risk effort than in the past. In the last two years, 65% of all new reserves worldwide were in deep water. In addition to these higher exploration costs, the quality of new oil is frequently lower and needs expensive processing.

But there is good news. With prices at this level, oil companies now feel an incentive to embark on exploration. Baker Hughes reports 1,234 rigs are now working in the US alone. As the world’s easily accessible fields are running dry, new oil can be produced—just at a higher cost.

Next, some perspective:

Oil would need to trade near \$80, not \$50, to be at the same price on an inflation-adjusted basis as it was in 1980. Back then, consumer spending on energy goods as a percentage of all consumer spending reached above 9%; today, it is roughly 5%. So, while the current high oil price is a problem, we have been in a much worse situation before.

What will happen?

We need to separate fundamentals from perception. So far, the only actual disruption in supply is temporary: four back-to-back hurricanes. “Inelasticity of demand” cuts both ways. Any increase in supply can move prices down quickly. Remember that oil was as low as \$10.72 in December 1998 after being above \$25 just two years earlier. Federal Reserve Chairman Greenspan has said that the long term oil futures market suggests that oil prices are going to stay *firm* for several years, but “*firm*” doesn’t mean \$50. The U.S. government officially projects the price to fall to an average of \$37 per barrel over the next 18 months. That may inspire some skepticism, but it is not impossible.

What does this mean to us as investors?

Companies with profits that are immediately affected by fuel costs will see quick downswings in their earnings, if they are unable to pass those costs through to their customers. However, high oil prices create opportunities for companies that will be rewarded for advanced technologies needed in exploration and development of oil. As investors, we will continue to monitor the international oil markets to avoid risk and to seek opportunities.



Not So Fast On Hedge Funds

By *Maye Albanez*

To “hedge” a bet is to protect against loss by betting a counterbalancing amount against the original bet. A “hedge” in the financial world is a transaction that reduces the risk of an investment.

Why many investors are chasing after them:

Many stocks and stock indices have lost money over the past five years, and with interest rates rising, bonds are seen as a poor bet. As a result, many investors are rushing to hedge funds, expected to deliver gains even in bad markets. Although the itch to find some way to rack up bigger gains is natural, it can lead to a strategy that is risky, not well understood and *very* expensive.

Following 1998, when major hedge player Long-Term Capital Management nearly self-destructed, hedge funds kept a low profile. Since then, hedge-fund assets have tripled to about \$1 trillion, growing at 15-20% a year. Most of this growth has come from pension funds, which typically got used to counting on annual returns of 8% or more to meet their obligations, and now are reaching for returns.

Another source of growth is a relatively new product called a “fund of hedge funds,” which has lured individuals who would not otherwise be eligible to invest directly in a hedge fund. These funds of funds have minimum investment levels as low as \$25,000. In contrast, hedge funds themselves require a much higher minimum investment—sometimes as much as \$1 million.

History:

In 1949, A.W. Jones established in the U.S. what is regarded as the first hedge fund. Jones combined two investment tools: short selling and leverage. Short selling involves borrowing a security and selling it in anticipation of being able to repurchase it a lower price in the market, at or before the time when it must be repaid to the lender. Leverage is the practice of using borrowed funds.

Jones believed there were two sources of risk in stock investments: risk from individual stock selection and risk of a drop in the general market. He maintained a basket of shorted stocks to hedge against a drop in the market, and he used leverage to amplify his returns. He went long on (owned outright) stocks he considered “undervalued” and short on those that were “overvalued.” The fund was split between stocks that would gain if the market went up, and short positions that would benefit if the market went down. Thus, the term “hedge funds.”

Today, the term “hedge fund” is applied to a number of private partnerships which typically borrow money or securities to buy investments, whether or not they subscribe to a balanced long-short strategy.

If you must, proceed with caution:

In principle, hedge funds make sense. Most try to exploit temporary price discrepancies in the market even if the overall markets are sinking. In an unregulated environment (as is the case with most hedge funds), the danger lies in the pressure and incentives to perform, often enticing the fund manager to multiply profits by borrowing many times over the amount of assets in the fund.

According to industry watcher PlanSponsor.com, hedge fund leverage is fairly low today, and large pension plans typically expose less than 10% of pension assets to the hedge fund market, though this exposure is increasing. Furthermore, at the fund-of-funds level, debt is mounting. Some are borrowing two or three times their assets, reasoning they are broadly diversified. Yet, if the underlying hedge funds start to borrow as well, it would create leverage on top of leverage, a recipe for disaster if things go badly. In a crisis, there are no rising returns to offset falling returns, and the “hedge” goes by the wayside.

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Fees:

A recent article in the *Wall Street Journal* addressing hedge fund fees stated that about 40% of the existing funds charge the traditional 1% in management fees, and fees in general are increasing. The article goes on to describe hedge fund firms whose asset-based management fees range from 2-9%. Investors in fund of funds pay yet another layer of fees, which can be 3% or more. In addition to management fees, there are “incentive fees.” Traditionally, these have been 20% of profits. Today, they may be up to 50% of profits.

Some \$80 billion flowed into hedge funds this year through August. The same opportunities are being chased by different managers, so returns have tended to diminish (returning only 1% on average for the first eight months of this year). The pressure to attain higher returns and justify hedge funds’ high fees are a constant concern for many managers, and *should* be a constant concern for their investors.

SEC concerns:

The SEC worries that performance concerns on the part of fund managers may lead to fraud, where hedge funds hide losses or misstate the value of their holdings. Consider last year’s mutual fund scandals, where some hedge funds schemed with investment firms to trade mutual funds on the basis of after-hours prices, allowing hedge funds to profit at the expense of long-term mutual fund investors.

Hedge funds that allow only accredited investors to participate (including financial institutions, pension plans, charitable organizations, corporations and wealthy individuals) are *exempt* from registration with the SEC because this type of investor is assumed to be knowledgeable enough to understand the risks.

Funds of hedge funds that offer their shares to anyone other than accredited investors are *required* to register with the SEC. The SEC can take action against non-registered funds if they suspect fraud, but it does not have routine oversight of unregistered investments.

Conclusion:

As with any investment, before considering an investment in a hedge fund or fund of hedge funds, it is important that you *fully* understand the risks, as well as the potential rewards. If you *must* invest in hedge funds or any other alternative strategies available in the market, we offer the following advice:

- Determine if the fund is regulated by the SEC.
- Understand the level of risk involved in the fund’s investment strategies, and make sure such risk is suitable to your personal investment goals, time horizon, and risk tolerance.
- Make sure you understand the fund’s valuation process, and the extent to which these securities are valued by independent sources, as many of the underlying securities can be highly illiquid.
- Make sure you understand the fee structure.
- Make sure you understand any limitations on your right to redeem your shares.
- Make sure you know with whom you are investing.
- Don’t be afraid to ask questions.

In closing, keep in mind that how successful you are as an investor boils down to four things: how much you save, how long you invest that money, how much you limit your investing expenses, and what kind of returns the markets produce while you are invested in them.

