



## Put your trust in Junior Oils



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If you are looking to gain exposure to oil & gas with a modest amount to invest in the sector, consider the CF Junior Oils Trust, managed by Sector Investment Managers.

Let me briefly re-visit the reasons (I have cited in oil share comment pieces) why it is prudent to have some exposure to oil & gas, both as a portfolio hedge and for capital growth.

In terms of general financial risk, although the stockmarket has remained buoyant amid soaring oil prices, if these consolidate in a \$50 range and move higher then it will undoubtedly hit economic activity - hence corporate profits. Saudi Arabia also presents a specific risk factor, accounting for 17% of global oil supplies, so a political/terrorist upset there would mean another hike in oil prices and a wider financial crisis.

Although I am cautious towards majority agreement about a financial trend - as now exists, for high oil prices - I would not try to counter it. Some profit-taking looks inevitable after many oil shares jumped in June/July, but there looks to be a strong probability of \$50 oil (or thereabouts) unless global growth weakens sharply or there is an upset in China. Oil is a finite resource and it may well prove hard to establish sufficient new production to meet longer-term demand.

I consider the best way to play this scenario is via small to mid cap 'hybrid' oil companies that combine strong cash flow from producing assets with (preferably) an exploration track record or at least intelligent exploration prospects in place. Exploration and drilling technology has improved in recent years, and a successful strike can transform capital value at this size of company - many times over, if a new oil province is involved.

Besides their intrinsic financial appeal, such 'E&Ps' are long-term takeover targets for the larger oil companies facing a crisis over reserves replacement - as illustrated by Shell's accounting fiasco.

Most City analysts still base projections nearer \$35 oil than \$50 as a benchmark. If \$50 oil (and higher) does pertain then there are likely to be more earnings upgrades in support of share prices.

If the case for exposure is sound, the risk of exposure to individual companies in this volatile sector presents a snag for smaller investors. With the CF Junior Oils Trust (JOT) now establishing a good track record since its launch last autumn - up around 20% and selecting 22 out of the 55 stocks in its universe - now is a good time to review this fund as means to diversify.

Like various small funds, JOT outsources administration to Capita Financial Managers, with fund manager Angelos Damaskos termed as 'principal adviser'. His background is investment banking, specifically with the European Bank for Reconstruction and Development, where he developed a portfolio oriented to mainly unquoted oil & gas companies. When I recently met him to discuss JOT's strategy and holdings, however, I found he has a firm grasp of the quoted oil & gas sector.

The initial charge (represented in the bid/offer spread) is 5.25% and annual charge 1.75%. I think one should take a long-term view with an investment like this; in which case the average annual fee works out more like 2-3% than 7% in year one.

Funds have been invested gradually and the trust is currently 8% in cash. Unit trust regulations stipulate no more than 10% cash although in adverse markets it is possible to be up to 40% liquid. Yet Damaskos does not intend to anticipate swings in oil & gas shares. With a board of directors of Sector Investment Managers overseeing him and a belief in a 'super-cycle' for commodities, Damaskos is more likely to ride out volatility.

BP and Shell are avoided on grounds of integrated oil majors have a major involvement in refining, production of chemicals and lubricants as well as retailing, where profit margins are less attractive. Another reason is their exposure to the Middle East. Damaskos is also wary of Russia and the Former Soviet Union due to uncertainties such as unforeseen taxes - citing the ongoing drama at Sibir Energy as an example of what can happen. Yet he sees overall merit in exposure to JGX Oil & Gas

(3.4%), Melrose Resources (2.6%) and Dragon Oil (3.6%) which have FSU exposure.

He concedes that Africa (where JOT has about 23% of its assets) is not without political risk, but cites it as a long-established oil-producing region. JOT's top three holdings - AIM-listed Sterling Energy, Dana Petroleum and Premier Oil - have key exploration interests in Mauritania.

Sterling, representing 9.6% of JOT, is expected to benefit from an astute financing deal with the Mauritanian government where Sterling gets an 8% stake in the Chinguetti oilfield - scheduled for first oil in the first quarter of 2006 and planned to rapidly achieve peak production of 75,000 barrels per day. Sterling's E&P portfolio has other promising projects such as the Gulf of Mexico where success in gas should boost cash flow, also Madagascar and the Cameroons.

Dana (7.0%) and Premier (6.1%) I have previously commented on (see archive) for their strong production bases and attractive 2-3 year exploration portfolios. I am a touch wary about Dana's chief executive and technical (i.e. exploration) director recently exercising substantial options and selling those shares, although Damaskos views this in context of oil industry executives retaining the scar tissue of low oil prices in the 1980/90s - i.e. they can't quite believe their current luck!

Noting Dana's adeptness in acquiring North Sea assets cheaply, then applying modern techniques to enhance recovery, Damaskos estimates that via other shares such as Paladin Resources (4.5%) and Tullow Oil (4.0%), production from the UK continental shelf represents about 25% of the trust. This looks good risk management.

By contrast and to give you another sense of where Damaskos draws the line for risk/reward, he has avoided direct exploration plays on the South Atlantic, such as AIM-listed Desire Petroleum and Falkland Oil & Gas, but he does hold Hardman Resources (4.3%) which is indirectly exposed to the Falklands besides Mauritania principally.

Another West African favourite is ROC Oil (5.7%), a well-managed blend of proven reserves, exploration potential and cash. ROC was one of the first companies to negotiate with the Angolan government after a civil war there, and gained onshore exploration close to Angola's most prolific offshore acreage.

Bowleven (4.8%) is an exploration play mainly in Cameroon that has risen from a buying price of about 350p above 500p, although Damaskos has taken some profits. The shares are seen as having further upside but without proven reserves it was decided not to let Bowleven become too big a holding.

In Western Europe, Northern Petroleum is a key holding (5.2%). Investors have been somewhat disappointed over drilling rig delays but Damaskos still sees good potential for its Isle of Wight gas exploration, also in Italy and the Netherlands. Northern is an exploration play yet judged a safer bet due to historic work on its licences.

The sector's potential for takeovers is shown by Edinburgh Oil & Gas being acquired, where JOT had 5% of its funds. The stake was mainly bought at about 200p a share relative to a take-out price of 317p.

Taking Edinburgh into account, portfolio turnover to date has been about 20%.

Damaskos sums up the exploration game by saying that 'exploration risk rarely pays off - but if it does, it pays in a big way.'

I think there is currently a happy-go-lucky approach to exploration shares and there will inevitably be some setbacks. That is why it is prudent to ensure good risk management in the E&P sector, by way of diversification and attention to calibre projects/management. JOT is well worth considering as a means to achieve this, especially if oil prices ease in the weeks ahead.

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