

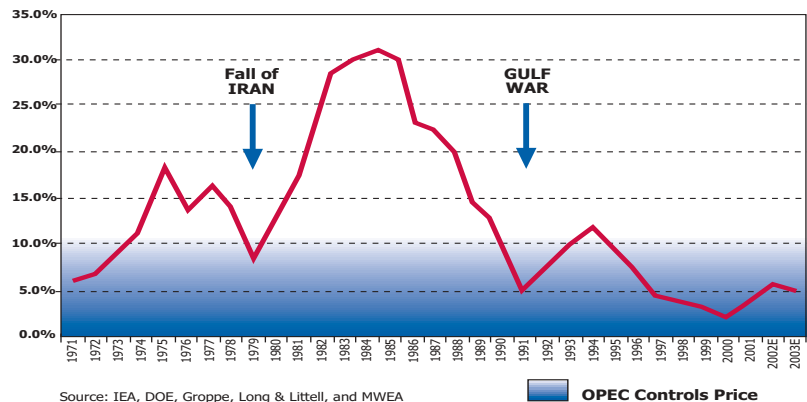
HARD ASSET INVESTING

The last five to six years have witnessed an unprecedented flow of private equity money into venture capital, buyouts, and other new ventures, mostly pointed at the technology and telecommunication sectors. This capital inflow was provoked by a willing IPO market that required very little in the way of real assets, operating history, or even profits or cash flow. In perfect hindsight, this was not investing, but rather some perverse form of arbitrage. The events of the most recent past couple of years are equally unprecedented in the collapse of a dramatically high number of these start-up entities, with a very large percent ending up with virtually zero residual value, destroying an estimated \$3 Trillion in TNT market value since March 2000. It's as if the "virtual economy" was a figment of imagination. Even supposedly "good" companies were smashed – Cisco down 87%, Akamai down 99.5%, for example, and the NASDAQ 100 down 80%. In late 1998, Moncrief Willingham Energy Advisers was founded to focus on a unique opportunity in the old economy "real" world. Combining our long wave energy cycle thesis with emphasis on the smaller energy companies with excellent management, good assets, reasonable relative valuations and prudent balance sheets, MWEA has over this past 3½ year time period generated positive returns of 180.2%, or 31.8% per year annualized. In this trying time in the investment world, it gives us some comfort to know that our companies are undergirded by a solid layer of real assets – barrels of oil and MCFs of gas in the ground that have real value, or in the case of oil service companies, technology supported equipment. **Hard Assets!**

HARD ASSETS FOR THE FORESEEABLE FUTURE?

Many of us who profited through the growth of the energy sector in the 1970s and through 1981 remember that by 1983 the only way you would consider a drilling rig a hard asset was to kick it. The underlying value of "hard assets" in the energy sector are reliant on the commodity prices of oil and natural gas. This graph vividly depicts the worldwide over-

Worldwide Spare Oil Production Capacity



supply of crude oil that occurred in the 1980s after a decade of increased capital investment that saw the rig count exceed 4,800. With overcapacity in the range of 30% through much of the 1980s, OPEC had no capability to dictate a price range, and commodity prices (and rig values) went through the floor. In 2002, with spare capacity much tighter at 5% to 6%, OPEC has much better control over prices. We recognize that commodity prices can temporarily spike above our target range (*Reference: MWEA January 15, 2001 Report "Looking For Waves, Missing the Tide!"*) of \$22 to \$28 for oil and \$3 to \$4 for gas, or below them, depending on geopolitical and macroeconomic factors and weather extremes. However, prices return quickly to the range, because those prices balance supply and demand. It is these new, higher ranges that make the "Hard Assets" hard. It is the *Tide* that dictates the ranges. Just as in the 1970s, when prices stayed much higher than expected until supply finally outran demand in the early 1980s (See Chart), the current decade will see firm prices and excellent returns on investment until capital flows into the energy sector become large enough to foster over-rapid supply growth. We are many years away from that point.

PUBLIC EQUITY MEASURE

Investors of all stripes were transfixed by the crushing washout of public equities in July. The steady stream of bad news about corporate malfeasance, and the revelation that the tech boom of the late 1990s was to a significant degree smoke and mirrors, resulted in a disgusted exit from equities. Good companies were treated just as badly as the villains, because they “could be sold.” The public energy sector was marked down like everything else during the worst of the decline. However, it is still worth reviewing how it fared. The energy sector has shown excellent relative performance in both the economy and the financial markets. Energy commodity prices are squarely in our long-held ranges of \$22-\$28/BBL for oil and \$3.00-\$4.00/MCF for gas. At this writing, oil hovers at the top of our range and the twelve-month strip for gas is \$3.75/MCF. This is a level that generates excellent cash flow and profitability, as well as excellent opportunity for investments. For the first half of 2002, our **FUND A** registered a positive return of +9.15%, versus a -13.74% for the S&P 500 and -25.54% for the NASDAQ Composite. We see every reason for a positive relationship for energy to continue, as any global economic recovery sufficient to float the tech boat and other segments of the economy will likewise produce clear sailing for the energy sector, given the continued fine balance between supply/demand during the early stages of this incoming *Tide*.

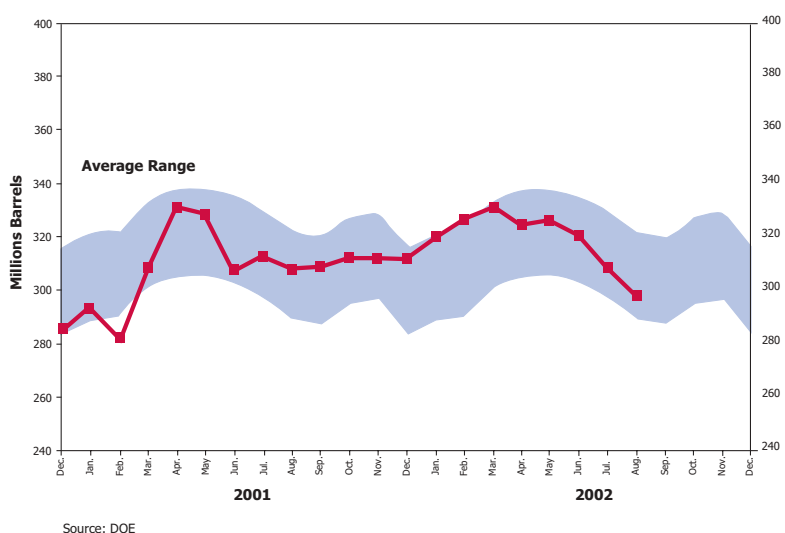
CRUDE OIL

The intricate dance between energy supply and demand has shown once again that our assertions about pricing being in the hands of OPEC are right on the mark. At the heart of our long-term up cycle *Tide* case is the proposition that there is very little spare oil production capacity in the world. This leads directly to the implication that relatively moderate swings in OPEC production can achieve any reasonable price target. In fact, in the last twelve months, we saw just how effective OPEC can be at price management. With the

recently announced revisions to real GDP, we now know that 2001 was an extremely weak year, the worst since 1992 in real terms and the worst since 1950 in nominal terms. Yet, despite this recession and the additional destruction of demand from the 9/11 events, and despite the growth in supply from the former Soviet Union, a 10% reduction in OPEC supply rebalanced the crude market and quickly brought prices back into their target range after the breakdown to \$19 in October/November, following 9/11. While some attribute current prices to a “geopolitical risk” premium or “War Premium”, we see it as a natural reflection of a less-than-normal spring inventory build and a tightening of crude stocks down into the lower half of the normal range in the U.S.

To put that in specific quantities, the Department of Energy (DOE) reports that end-of-June U.S. total oil and product inventories are 4 million barrels (BBLs) below end-of-December levels. The normal seasonal build during this half of the year is 35 million BBLs. Thus inventories are about 40 million

Stocks of Crude Oil, January 2001 to Present



BBLs lower than expected (tighter). There is also evidence that inventories have declined in parts of Asia and on the water; nor did they build much in the rest of the OECD. The mid-year International Energy Agency (IEA) report shows total OECD inventories up 3 million BBLs from December to June (2,626 mm/BBLs versus 2,623), a trivial increase for a period with all the rhetoric about OPEC cheating and “too much oil.” Add “on the water” and the total is down.

With our focus on the long-term energy up cycle (*Tide*) we find ourselves primarily looking at secular factors such as global industrialization, population growth, and energy investment trends. However, it is worthwhile to look at how short-term events fit within our very positive long-term outlook. The seasonal swing upward in oil demand starts in the third quarter and peaks during the first. Thus, we are looking at a period of rising demand with OPEC quotas frozen at a level that was insufficient even to build inventories normally during the spring trough of demand despite cheating. The IEA currently forecasts the demand swing to be 2.5 mm/BBLs per day. In other words, inventories will decline sharply over the coming months unless OPEC cranks up production soon. Given the six-week lag between Persian Gulf output and landing in the U.S., a decision at their September meeting for October quotas may be too late to prevent some disruptive price action around year end.

NATURAL GAS

Natural gas fundamentals are also supportive of strong sector performance in late 2002, 2003 and beyond. Declines in production that we have been highlighting for some time gather momentum every day that the gas rig count stays down at current levels (below 800). Presently the year-to-year change in U.S. gas production is down about 6%, or roughly 3 billion cubic feet (BCF) per day. Combined with modest up ticks in industrial gas demand, this supply decline has resulted in a noticeable tightening of the balance, which is rapidly clearing the excessive inventory position left over from last year’s non-winter. Texas and Louisiana provide about 40% of the U.S. gas supply. It is worth studying the latest available figures for a look at the rate of change.

YEAR TO YEAR CHANGE IN OUTPUT		
	Texas	Louisiana
November	- .9%	+ 1.2%
December	- 2.1%	+ 1.1%
January	- 2.0%	- 5.9%
February	- 2.8%	- 7.8%
March	- 3.2%	-14.0%
April	- 3.7%	- 9.6%
May	- 6.2%	- 9.2%

The demand side of the natural gas equation can be estimated by analyzing industrial production data. Careful deconstruction by industries allows for a gas-weighted calculation. The numbers show a gain of slightly less than 3% for the second quarter, after a first quarter gain of slightly more than 3%. As industrial production continues to recover, this demand function will also rise. Regardless of weather, demand is rising against a backdrop of falling supply. It is not only falling here in the U.S., it is also falling in Canada, where Alberta field receipts into pipelines are down 3.6% year-to-year. Whether it is six months from now, or less, the price of gas will have to rise enough to engender much higher drilling activity and crimp industrial demand. Again, these are the conditions that result in higher profitability, upside surprises, and performance.

LONG-TERM VIEW

The seasonal and short-term considerations captured above all point to positive performance ahead. Investors, however, should be much more focused on the long term. We would reiterate that worldwide energy demand continues to grow. As we have repeatedly emphasized, short-term macro economic events (recessions) can suppress demand growth temporarily, but it soon snaps back to the 2% secular growth trend. That trend is driven by world population growth, plus the gradual intensification of per capita usage that stems from industrialization, not the turnstyle count at Walt Disney World nor the number of SUV units being sold. One good anecdotal example of this growth in energy demand is road freight ton-miles in China. This is “stuff” transported by trucks using gasoline or diesel. In 1990 it came to 200 Billion ton-miles. In 2000, it was 400 Billion ton-miles, a growth rate north of 7% and close to the overall GDP growth rate for the country. All signs point to the growth rate continuing, which generates incrementally larger quantities of required fuel. All over the developing world, examples like this can be found. There is still the basic condition of energy demand growth bumping up against supply that has been crimped by under-investment for 20 years. This is the big picture condition that puts the short-term factors in play as discussed above. The opportunity for superior returns in the energy sector is a decade-long opportunity, as occurred in the 1950s and again throughout the 1970s. We have described these circumstances in our writings as *Tides*, and they spell energy sector long-term performance with valuations supported by these “old economy” boring hard assets.

Moncrief Willingham Energy Advisers, L.P.

1100 Louisiana, Suite 4848

Houston, Texas 77002

Tel: (713) 658-9900

Fax: (713) 654-0015

<http://www.energyadvisers.com>

Lee P. Moncrief
General Partner

B.J. Willingham, CFA
General Partner

George W. Matcek
Senior Associate

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