Energy and Utilities:

Sector Overview and Recommendations

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Mark Burroughs
Joan Williams

Energy and Utilities Sector Report and Analysis

General Overview

The Utilities and Energy sectors are tumultuous places to invest. Several very unusual factors, as well as discouraging trends in underlying commodity prices, point to the uncertainty of the sectors. However, we believe there are companies who will be able to survive both scandel and downturn, and these present attractive opportunities to being the sectors together to slightly underweight of the fund, a position that was attempted last year but that result in heavily underweight, by passing a largely spectacular run-up in energy-related equity values. We do not believe the next peak of the cycle will come anywhere close to the imbalances that drove equity values high in 2001, however, a healthy recovery still represents an upside to equities that have otherwise been crushed by some of the following factors:

- Fallout from the California energy crisis of 2001 continues to beat on equity values of involved utilities (for example, El Paso, Calpine)

- The Enron debacle continues to add unpredictability to the future equity values of energy merchants. In addition to accounting practices (which it is predicted other energy merchants followed), methods of booking trading profits and losses, patterned after Enron, will likely be examined. With the removal of Enron as market-maker in gas and power trading markets, Nymex and Ercot (as well as other grid markets) volatility has lessened. Energy merchants weighted toward an asset-light strategy will have difficulty being as profitable in the absence of volatility. There is a general psychology that by association any peer companies of Enron will be damaged by their demise, at least in the short term.

- Uncertainty over the future of power deregulation

- Increased production costs for Integrated and E&P companies is making reserves more expensive to replace. Forecasters expect many (following Royal Dutch / Shell's announcement to this point) to either cut production volume estimates or overrun production costs. Return on Capital Employed gains which made some integrated stocks so attractive last year (e.g., Exxon Mobil) appear to be drying up.

- Underlying commodity outlooks are not forecasting any major shifts in supply or demand. Therefore, what small creep-up in price expected in both oil and gas will be more contingent on economic recovery than current conditions in production or inventories.

- The financial crisis in Argentina threatens all E&P companies operating in the country and offshore, including oil field services, as the Argentine government is threatening to assess a heavy tax or royalty on all oil and gas being extracted from the territory. Many E&P precluded the situation in Argentina by selling reserve assets in the latter part of 2001 (including Devon Energy)

Merger activity in the sector has slowed considerably post-Enron bankruptcy with the exception of the PanCanadian merger with Alberta Energy. *We believe that this could pick up* as the direction of commodity prices becomes more clear and as debt-laden E&P companies in the prolonged cycle are forced to sell at bargain-basement valuations to raise cash. The following list presents, by comparison, only a handful of deals relative to the period of higher oil and gas prices, ending with Summer, 2001

Recent Mergers and Acquisitions (sorted by announcement date with deal size and focus)

Q3 2001	Amerada Hess acquired Triton Energy ($3,157.9 MM) Upstream
Q3 2001	BP acquired EON ($2,908.2 M) Downstream
Q3 2001	Burlington Resources acquired Canadian Hunter ($2,211.1 MM) Upstream
Q3 2001	Dominion Resources acquired Louis Dryfus ($2,374.7 MM)
Q3 2001	Devon Energy acquired Anderson Exploration ($4,674.3 MM) Upstream
Q3 2001	Devon Energy acquired Mitchell Energy ($3502.5) Upstream
Q3 2001	Duke Energy acquired Westcoast Energy ($8,407.0) Midtream
Q3 2001	Electricite de France/Fiat acquired Montedison ($15,304.0) Power
Q3 2001	Endesa acquired Elettrogen ($3,239.5) Power
Q4 2001	Chevron Corp./Dynegy Inc./Texaco, Inc. acquiring Enron Corp. ($30,045.8 MM) Corporate
Q1 2002	Pan Canadian acquires Alberta Energy ($6,200.0) Corporate
Q1 2002	Petro-Canada acquires Veba Oil ($3,200.0)

Utility Sector

Sector Overview and Industry Trends

The following shows a graphical representation of the performance of the utilities sector versus the S&P500:

Market Drivers and Economic Outlook

The Enron debacle has probably been done more to damage equity valuations of utilities than the very weak underlying equity prices. Very little has changed in the light of low commodity prices and oversupplies of natural gas since the last sector report. This is a strong indicator that the trough of the cycle has been prolonged with no seasonal factors reversing its trend, and industry perception, as mentioned in the general summary, is bearish across most of Enron's industry peers. While last summer's mild temperatures did not invoke rising commodity prices, this winter does not seem to be doing the trick either, though brief periods of severe cold have occurred in the Northeast. Meanwhile, the market opportunities presented by Enron's exit have been minimal due to decreased market volatility in Enron's absence. Exceptions to note are AEP, which has been able to pick up power contracts that would ordinarily have been part of Enron's market share, as well as partners of the Intercontinental Exchange, which picked up most of Enron's online trading business.

General economic conditions affects underlying commodity demand that is felt through the distribution outlet of utilities. An extended recession continues to offer little encouragement that economic industry will spur greater energy demand. In addition, utility expansion will feel the pressure to minimize capital intensive expenditures, and probably would have initiated these projects under lower interest rate conditions of the latter part of last year, though expansions could still be seen as long as rates fail to reverse. Still, debt levels in this type of industry outlook are likely growing and being monitored closely.

Current Holdings and Recommendations

We recommend to emphatically underweight in the utilities sector and slightly over weight in the energy sector. There still seems to be significant downside potential in utilities stocks, and the energy stocks still hold some strong balance sheet, attractive risk/reward offerings.

Currently the AG holds only Dynegy in the portfolio. Last year, both El Paso and Enron were sold after posting substantive losses. We are strategically holding Dynegy below its stop price in order to wade out the effect the Enron crisis has had on this stock. IF the company can continue to post a steady earnings stream, we believe at some point the market will its their upside potential. At this point, most of the write-off costs seem to have passed, though the market could still be pricing out overall fallout effect the Enron debacle will have on the utilities sector as a whole, particularly in light of the future of deregulation. This currently leaves us slightly under weighted in the utility sector, a position we plan to make up for in the energy sector.

Dynegy is currently trading at $21.25.

Energy Sector

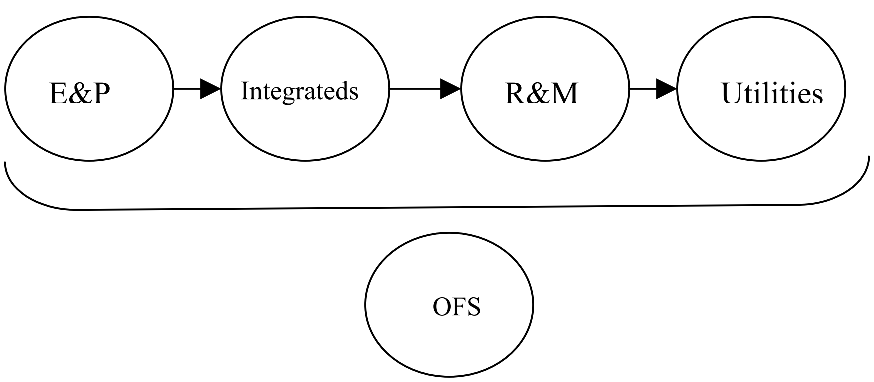
The following shows a graphical representation of the performance of the energy sector versus the S&P500:

Sector Overview

The Energy Sector is comprised of several subgroups: Exploration & Production (E&P), Oil Service (Drilling and Equipment), Refining and Marketing (R&M), Domestic Integrated Oil, and International Integrated Oil (Integrateds).

The Domino Effect.

Economic and Industrial supply and demand factors, OPEC, in addition to weather and other variables affect commodity price trends. Our research has shown that while some energy companies are closely tied to movements in the stock market, others are tied to the cycle of the underlying energy commodity. This cycle is most simply demonstrated below, through which the effects of the variables will be felt:



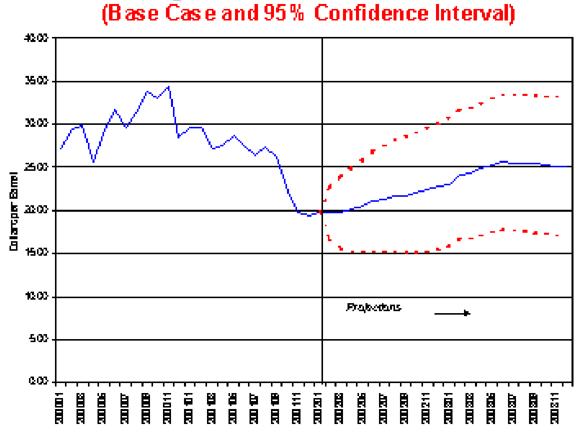
Energy Sector Trends

There are a number of important trends to look toward in order to dissect the energy industry and its future:

U.S. Petroleum Outlook. OPEC's stated intention to reduce crude oil output beginning in January has been mostly successful. OPEC-10 crude oil output (OPEC minus Iraq) fell by an estimated 1.1 million barrels per day in January, or about 70 percent of the officially announced quota reductions. Production rates at these levels confirm expectations for steadily increasing average crude oil prices in 2002.

Demand for domestic petroleum products in 2001 averaged 19.65 million barrels per day, down 47,000 barrels per day, or 0.2 percent, from 2000. This was complicated by the decrease in jet fuel demand following September 11. The January, 2002 retail price for regular gasoline averaged $1.11 per gallon, a considerable drop from the record high in May, 2001 price of $1.70 per gallon**.** Inventories of gasoline are well within the "normal" range as the spring driving season approaches. Pump prices are expected to gain about 15-16 cents per gallon by late spring from the current average price even without demand pushed by economic recovery.

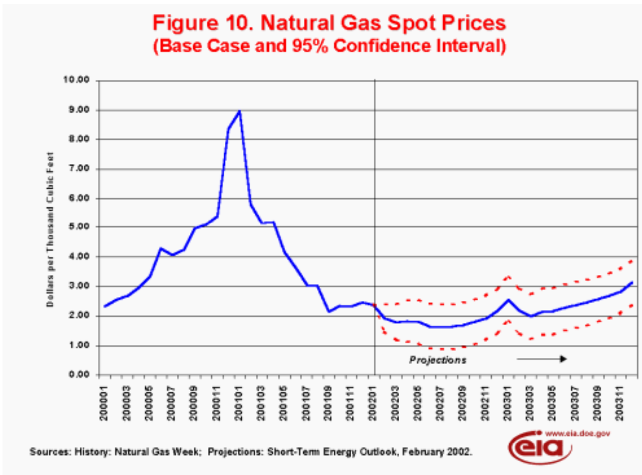
Figure 1. WTI Crude Oil Price
(Base Case and 95% Confidence Interval)



Sources: History: EIA; Projections: Short-Term Energy Outlook, February 2002.

U.S. Natural Gas Outlook. Average daily spot prices at the Henry Hub have slipped below $2 per million Btu more than once since November, 2001, contrasted with the Henry Hub spot average of about $8.30 reported for January of last year. Henry Hub spot prices have remained in the $2.30-$3.00 per million Btu range despite very weak fundamentals. Natural gas prices are expected to hover around the $2.00-per-million-Btu level for early 2002. Any recovery in late 2002 or early 2003 depends on recovery in the U.S. economy and the slowdown in U.S. drilling. The latest statistics from Baker Hughes show that drilling in the United States has fallen to levels not seen since July 2000, meaning that oversupply has the potential to turn to shortage if the demand trend reverses.

Very mild winter weather conditions continue to dampen heating season energy demand patterns. Despite efforts by refiners to adjust production rates to deal with low profitability and excess storage, higher-than-expected product inventories continue. This affects all household heating sources, including heating fuel as well we natural gas and electricity demand.



Electricity Outlook. Total annual electricity demand growth (retail sales plus industrial generation for own use and other direct sales) is estimated to have been flat in 2001, but expected to revive slightly by 0.6 percent in 2002, and by a further 2.7 percent in 2003. This is compared with estimated demand growth in 2000 of 2.8 percent over 1999's level. Electricity demand in the industrial sector in 2001 was adversely affected by the overall economic slowdown, particularly as illustrated by falling industrial output. Electricity demand growth is expected to rise in the forecast years mainly because the economy is assumed to gradually rebound.

Technology. Technology advances could improve finding and drilling success rates, but push E&P to harsher and deeper environments. Detection techniques aided by advanced radio frequency technology have made possible location and drilling in deeper and harsher environments, also making costs to do so more attractive than the messy, high-pressure techniques being used to break up small existing pockets in more shallow water or land environments.

Current Holdings and Recommendations

Our focus is on buying now to slightly underweight sector to take advantage of eventual recovery in commodity prices by investing in companies that have the financial strength and discipline to ride out a prolonged downturn.

For Exploration and Production companies, this will mean looking for companies that are aggressively replacing their reserves, have high quality reserves, have committed to long-term production growth, have a reserve balance between oil and gas or are weighted toward gas, and companies with a low, sustainable cost structure. Our recommendation and subsequent purchase of Anadarko met this strategic criteria.

For Oil Field Service Companies, this will mean looking for companies with diversified and in-demand technology, superior research and development efforts, service to many types of activities (ability to service both exploration and production), and financial strength and discipline to fund ongoing design and manufacturing activity even during a prolonged downturn. Our recommendation and subsequent purchase of Hydril met this strategic criteria.

Our holding in Valero Energy (NYSE: VLO) has performed well since purchase, which was prior to the company's merger with Ultramar Diamond Shamrock, another refining company. In compliance with regulatory measures associated with the merger, the company has been mandated to divest some refining interests in California. Its most recent divestiture to Tesoro was not made at a significant premium and was concluded with Tesoro's ability to finance in question – a major factor in asset sales given the prolonged downturn in commodity prices. Although the Valero holding has busted through its price target, we believe that promising forward earnings and the rebound of commodity prices will boost the stock higher. We continue to monitor this holding daily.

Shares of Valero are currently trading at $45.37.

Two stocks were recently purchased on order to boost our underweighting and to time the trough of E&P and Oil Field Services industries. These are Hyrdil (NYSE: HYDL) and Anadarko (NYSE:APC).

Hydril is a small-cap OFS which is expected to benefit from a general upswing for oil field services in the latter half of this year and which is devoid of the deteriorating balance sheet problems that blemish other oil field service offerings. Technology, Hydril should also benefit in the intermediate and long term from technology it uses for the growing exploration and production in harsh and deep-water environments (e.g., North Sea, Gulf of Mexico).

Shares of Hydril are currently trading at $17.10.

Anadarko was purchased based on the rationale that a strong E&P, indeed, a market leader, would be best purchased in the trough to take advantage of future upswing in oil and gas prices. The company is heavily gas weighted and has stuck to a development strategy to grow to be the largest domestic E&P company. We believe the company will continue to make heavily discounted reserve acquisitions, and that it will benefit from any upswing in gas prices. The company has a strong balance sheet and is a long-term pure play in natural gas price improvement.

Shares of Anadarko are currently trading at $48.06.