INVESTING IN ENERGY
INCORPORATING ENERGY IN YOUR INVESTMENT PORTFOLIO

Most investment portfolios have general exposure to the energy industry via equity or fixed income positions with obvious connections to the energy industry. However, a more focused approach to incorporating energy may afford an investor - and their portfolio - more specific benefits.

Identifying how to strategically, yet prudently, include energy into a portfolio can be a difficult task. This paper will highlight several avenues for investing in energy, with a focus on oil natural gas-related energy investments. Although alternative energy investments such as wind, solar and water may be viable options, they will not be covered in this whitepaper. Below is a brief explanation examining strategic energy investment opportunities in today's market, along with the potential risks and benefits involved.

<u>Tax-Motivated Investment Strategies</u>

There are several energy investment strategies and structures attractive to tax-motivated investors. While almost all energy investments contain some tax benefits due to depreciation allowances, etc., the three investments covered below are most appropriate for those looking to mitigate their tax liability to the maximum possible extent.

Drilling Partnerships - Focused in the development stage of energy, drilling partnerships can be speculative and may involve a high degree of risk. However, in exchange for that risk, the investor may receive significant tax benefits. Drilling partnerships invest primarily in development projects, which allow a deduction for Intangible Drilling Costs (IDCs). IDCs include expenses paid for wages, fuel, repairs, hauling, supplies and other essentials costs for drilling a well and preparing it for the production of oil or gas. Investors can benefit from portfolio diversification, in addition to a substantial tax deduction, due to the Intangible Drilling Costs. IDCs can, at the election of the investor, either be deducted in the year paid or amortized over a sixty-month period.

Direct Title Programs – Energy investors have long enjoyed the benefits of direct title programs, particularly those looking to mitigate taxes due to a sale of a property or farm via a 1031-like kind exchange. IRS code has confirmed that oil and natural gas royalties qualify as "like-kind" to all other forms of Real Property. This allows investors to diversify their portfolios by taking advantage of the 1031-exchange tax deferral by exchanging between brick-and-mortar or agriculture real estate to direct title royalty interests.

Strategic Income Partnerships - Energy partnerships can also be strategically designed to address specific tax needs of the investors. A Passive Income Generator (PIG) is a partnership intended to provide passive income, which serves several applications. The primary investor set would be ones looking to off-set previously "earned" passive losses, such as those attained in a direct real estate partnership. With the recent downturn in real estate prices, many investors have accumulated an amount of passive-loss carry forward that could be difficult to utilize in their lifetime. However, a strategic income partnership providing passive income can help off-set the passive losses. An Energy PIG will typically focus on acquiring income producing assets, which benefit from depletion and depreciation deductions while generating passive income.

Income Investment Strategies

In addition to the benefits afforded in tax-motivated investments, investors seeking alternative methods of income may find energy an attractive source. Today, most investors are working to identify conservative avenues to supplement decreased fixed income yields. While most might not initially consider energy as a conservative source for income, there are investments structured to provide consistent income, as well as the potential for growth.

Oil, Natural Gas and Coal Royalties – Traditional royalty portfolios have no debt, leverage or drilling costs, making it one of the most conservative ways to invest in the energy industry. Royalties are paid off of the gross revenues of an underlying asset, typically oil and gas wells. Royalty owners receive the benefit of current and future production by those wells, without the costs and liabilities of drilling. Royalties are commonly used as legacy investments, as the life of the underlying assets have the potential to outlast the life of the investor. Royalties can provide income diversification and portfolio diversification, in addition to the ability to capitalize on escalations in energy prices.

Inflation Protection Investment Strategies

Inflation, a rise in the general level of prices of goods and services, has been and remains one of the greatest potential threats to any long-term pool of funds. Real assets, such as oil and natural gas, have historically provided attractive returns during inflationary times when traditional stocks and bonds have performed poorly. In effect, an allocation to oil or natural gas may serve as an insurance policy against the harmful effects of inflation.

Oil, Natural Gas and Coal Royalties – There are multiple investment vehicles and strategies that can specifically provide protection against inflation. Royalties, which seek to provide a growing income stream can help offset the impact of inflation on an investment portfolio. While the income paid on a royalty portfolio can be negatively impacted by low productions or prices, it is positively impacted by increased production and upward price movement. As the price of oil or natural gas increases, so would the amount paid to the royalty owner. Royalties can provide protection against unexpected inflation, as well as sustained periods of oil and natural gas price increases.

Mineral Interest Ownership Programs - Another strategy to combat the negative impact of inflation on an investment portfolio would be investing into an opportunity-oriented energy vehicle. Mineral Interest Ownership is centered in the first stage of mineral development. These investments focus on the identification and purchase of mineral ownership interests in established or developing oil and natural gas fields. While somewhat riskier than a royalty investment, there can be greater opportunity due to the potential for growth and development. Areas that exhibit strong signs of future leasing, permitting and drilling activity represent the greatest potential for mineral value appreciation and are key acquisition targets. Increased demand for the underlying minerals (oil and natural gas), leads to increased production and pricing, all of which positively impact the potential return on a mineral interest portfolio.

Diversified Investment Strategies

In general, a targeted approach to energy investments, or any real asset investment, can contribute two significant benefits; valuable diversification and reduced volatility of an overall portfolio. Energy has historically had low or negative correlations with traditional investments such as stocks, bonds, and cash. While energy infrastructure investments exhibit slightly higher correlations, they can still be a constructive instrument in a portfolio.

Master Limited Partnerships - Master Limited Partnerships (MLPs) are publicly traded partnerships, the majority of which operate in the energy infrastructure industry. Attempting to construct an energy allocation, while ensuring diversification, is difficult in most portfolios due to investment price constraints. MLPs typically have lower minimums than private investments, allowing most investors entry. MLPs primarily own assets that engage in the transportation, storage, processing, refining, exploration, mining and production of natural resources. Segments included in Energy MLP investments are; Exploration and Production, Pipeline, Processing, Propane, Coal and Marine Shipping MLPs. Typically MLPs participate in several or all of the segments listed, which may allow investors exposure to new areas of the energy industry. Due to their traded nature, MLPs cannot assist in addressing investment correlation or portfolio volatility issues, a primary motivated for many direct energy investments. However, used in concert with non-traded, direct energy investments, MLPs may provide liquidity and additional diversification to an investment portfolio.

To learn more about investing in energy, or real asset investments in general, please contact Shawn O'Shaughnessy at (314) 725-2000 or shawn@alveryb.com.

The ideas discussed above are for consideration by qualified investors and are not suitable for all. As with any tax-motivated investment, you should consult with your tax professional for advice regarding the application of these investments to your specific situation. Working with investment professionals who have a deep understanding of energy investments in addition to non-traded products is imperative, as some of the concepts discussed have limited liquidity, which might result in an investor having difficulty upon exiting.