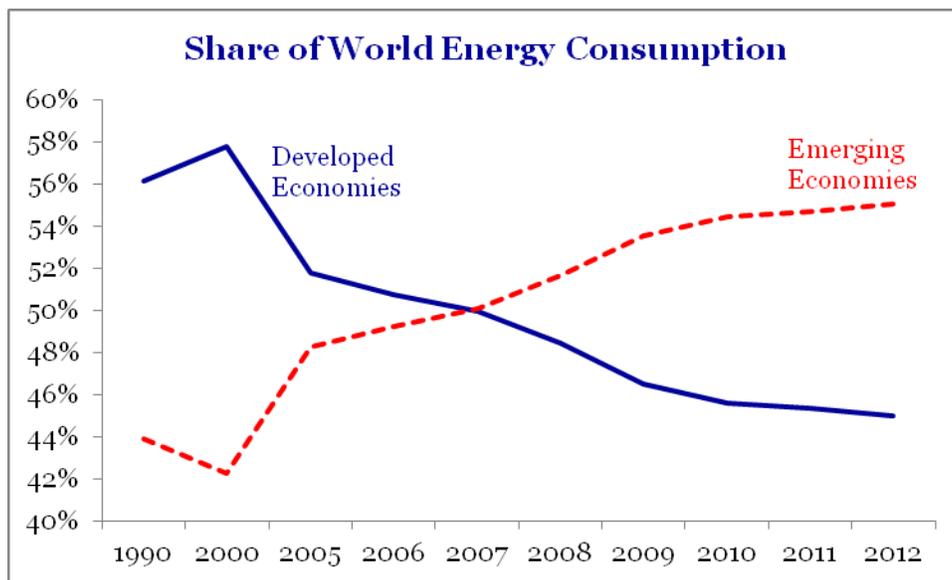


SAYBROOK CAPITAL

INVESTMENT OUTLOOK

First Quarter 2012

A long-standing client recently asked if we saw any emerging industry that could potentially impact the economy and investors as significantly as information technology has over the last 20 years. “Vast changes are afoot in the energy patch, and we are still in the early innings,” we broadly pontificated, certain, at least, of the effects already being felt in the economy. But, as usual, picking winning investments in a transformative period is the challenge, as tech investing in the late 1990s proved. Today, despite exciting developments in the sector, energy-related investments have mostly lagged during the general rebound in equities over recent months. In our perhaps contrarian way, this letter focuses on surprising changes underway in the energy industry and how Saybrook Capital has invested to capture potential long-term returns.



Source: Strategas Investment Partners

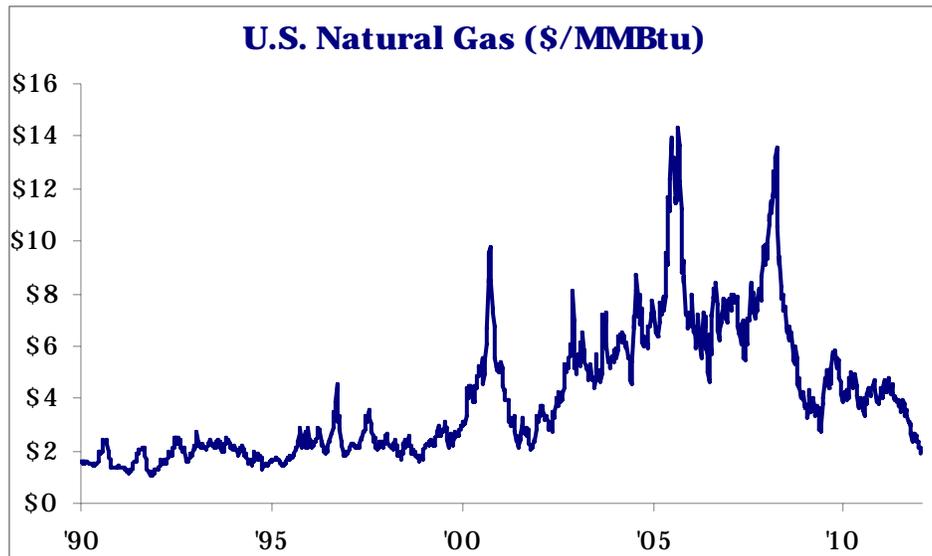
Sea-Change for Demand and Supply:

Industrialization in emerging economies such as China, India, and Brazil have led to an acceleration in demand for energy to fuel transportation, factories, electricity, and infrastructure. The demand in these regions for petroleum, natural gas, and coal has been breathtaking, as a growing middle class strives for the conveniences that we take for granted – from electricity to cars. This phenomenon has more than offset the moderating demand for energy in developed countries, with usage curbed by slower economic growth and

conservation (see previous chart). This trend is expected to continue, with ExxonMobil management reporting at their recent investors' meeting that, compared with flat consumption from the U.S., Europe, and Japan, they expect energy usage in developing countries to grow 70% in the next twenty years. This emerging market demand has led to a decade-long surge in nearly all commodities, particularly petroleum.

More recently, a completely unpredicted change in supply has occurred as increased demand, high prices, and revolutionary technology have led to massive resource discoveries, most notably domestic natural gas. These breakthroughs have been driven by an unlikely alliance of engineering-oriented companies with improved drilling expertise, entrepreneurs at small exploration companies that take risks where larger less nimble competitors would not, and a patchwork of small private leaseholds rather than billion dollar offshore projects. In a classic example of supply-demand dynamics, the high energy prices of the 2005-08 period accelerated research and development investments which have led to both the discovery of far vaster energy reserves than previously known and the technology to profitably extract them. The biggest advances are in hydraulic fracturing or "fracking" (the controversial process of deriving natural gas and oil from shale rock formations with pressurized water, sand, and chemicals) and horizontal drilling (the ability to dig wells that go any direction, exploiting formerly unreachable deposits). Neither of these technologies is brand new, but high energy prices and scientific advances made them commercially viable.

The U.S. is now producing more petroleum than thought possible five years ago when experts believed production had peaked, but the increase in natural gas supply has been more dramatic. Discoveries of abundant reserves in areas as diverse as Arkansas, Wyoming and Pennsylvania, as well as the usual oil belt states, combined with the aforementioned technologies, have driven a nearly 30% increase in domestic natural gas production since 2005 (a year when future production *declines* were widely predicted). Currently, the oversupply of domestic natural gas, exacerbated by a record warm winter, has driven U.S. prices below \$2 per MMBtu (thousand British Thermal units), a ten-year low. As recently as last year, U.S. natural gas was above \$4 per MMBtu. Paradoxically, prices are between \$10 and \$16 per MMBtu in markets such as Asia and Europe, where U.S. supplies, traditionally delivered by fixed pipelines rather than ships, cannot easily reach.



Source: Strategas Investment Partners

Today natural gas is predominantly used as heating fuel (51% of U.S. homes use natural gas, with the remainder mostly oil and electric) and electricity generation (coal 39%, natural gas 27%, nuclear 21%, hydro-electric 7%, wind 3%, solar 1%, other 2%). Although natural gas is not a renewable resource like solar, wind, nuclear, or hydro-electric, it is domestically abundant, possesses a relatively strong exploration and production safety record, and produces approximately 30% less carbon dioxide than oil and 50% less than coal. These advantages were underscored after the nuclear meltdown in Japan in March 2011. In the aftermath of the Fukushima disaster, Japan has closed 53 of its 54 nuclear reactors, and Germany has decided to phase out nuclear power completely. Simultaneously, new Environmental Protection Agency (E.P.A.) regulations have restricted the development of new coal-fired electric utility plants in the U.S. These changes significantly shift the demand curve toward natural gas. Currently, supply still vastly outweighs demand, and natural gas trades at a price equal to only 15% of that of oil (per equivalent unit of output), while natural gas and oil have historically traded near parity.

This divergence in fuel prices has widened recently, but the dynamics of markets and trade will almost certainly close the gap between the record low price of domestic natural gas versus foreign natural gas and petroleum. Such a price vacuum creates opportunity and invites action. To wit: the Federal Energy Regulatory Commission just approved a \$10 billion natural gas liquefaction terminal in Louisiana, for the first time enabling the exportation of domestic oversupply to natural gas-starved markets in Europe and Asia (a dramatic reversal of the terminal's prior role as a regasification/import plant). In cold climates,

customers continue to switch their furnaces from oil to natural gas. Driven by simple economics, power plants are increasingly converting from coal to natural gas (as General Electric, a global manufacturer of natural gas turbines, just indicated on its first quarter call). U.S. chemical companies, seeking access to lower-cost gas-derived materials, and other manufacturers that are attracted to cheaper utility costs are considering reversing earlier decisions to move their factories overseas. Oil and gas drillers themselves, understanding energy markets the best, are converting power generators on drill rigs to run on liquefied natural gas instead of more costly diesel fuel. Entrepreneurs are promoting ambitious plans to expand the use of natural gas as a *mainstream transportation fuel* – heretofore the Holy Grail. One approach is to fuel engines with compressed natural gas, but this would require converting thousands of service stations and, therefore, is more practical for truck fleets. Incidentally, public buses, which return to a common depot each night, are early adaptors of compressed natural gas (including approximately one-third of New York City’s fleet). Most of these changes involve large regulatory and/or infrastructure changes and will take time. Nevertheless, these benefits are real and will have lasting ramifications. As natural gas is increasingly deployed across new markets and finds innovative uses, companies with vast shale reserves should thrive as demand rises and the commodity price trends back towards equilibrium with other forms of energy.

Saybrook’s Energy Investments:

Amidst these significant changes in demand and supply, we have increased our energy investments with positive results. We owned XTO Energy from 2004 until they were bought by ExxonMobil in 2010. Attracted to their productive onshore domestic natural gas and oil reserves, their technological know-how, and the expertise of their engineers, we were pleased to realize 230% gains from our initial purchases. XTO was acquired using ExxonMobil stock, and for most accounts we elected to retain the shares, recognizing Exxon’s track record of operating excellence and superlative capital allocation. Following that success, we recently purchased Southwestern Energy (SWN), another gas exploration and production business in the mold of XTO. While the current glut of natural gas supplies has hurt SWN’s stock price, as long-term investors we think the best time to buy commodity-based assets is when their values are depressed. We spoke with SWN’s CEO, Steve Mueller at this month’s Independent Petroleum Association meeting and continue to be impressed with the company’s consistency amid industry upheaval, price hedging discipline, and ability to maintain profits in the current pricing climate.

Another reason we have liked SWN is their constructive approach to sound state and federal environmental regulations, including those unveiled this month by the E.P.A. These first-ever federal rules will require hydraulic fracturing to incorporate technologies that capture methane and other pollutants, efficiently limiting emissions. Additional requirements to safeguard water supplies are also likely to emerge. We believe SWN benefits from a consistent regulatory environment and that their compliance will surpass these new standards.

We currently own several high-quality leaders in the broadly defined energy space. The following is a list of companies held in nearly all of our portfolios and the ways (some obvious, some unexpected) that they are exposed to growing energy demand:

ExxonMobil, the world's largest publicly-traded energy company, is now the largest U.S. producer of natural gas. A leading global exploration and production company, Exxon is also known for refining, distribution, liquefaction, and chemical manufacturing.

Schlumberger is the world's leading oilfield services company. The company has global reach in oil and natural gas services ranging from seismic exploration to drill-bit technology.

Southwestern Energy is the eighth largest U.S. natural gas producer with major assets in the Fayetteville and Marcellus Shales. Advantages include one of the lowest cost structures in the industry and significant "midstream" (pipeline) assets.

General Electric's energy infrastructure division, representing 32% of the company's consolidated revenues, manufactures and services heavy-duty gas-powered turbines for utilities, equipment for the oil and gas industry, and clean energy products like wind turbines and solar farms.

Honeywell's businesses, in areas we define as "efficiency technologies," represent 53% of total revenues, including climate control, low-emission turbochargers, and bio-fuel development.

Emerson Electric has 43% of revenues in the areas of Network Power and Climate Technologies, focusing on areas such as smart-grid technology and data-center cooling.

Berkshire Hathaway's MidAmerican Energy subsidiary supplies 2.4 million customers and operates the largest U.S. wind generation utility; its pipelines deliver 8% of the country's natural gas.

Duke Energy supplies electricity to over 4 million residents and businesses in the Southeast, Midwest, and Latin America. Duke also provides natural gas by fixed pipelines to 500,000 customers.

"A new boom in energy production in the United States holds the promise of abundant and cheaper fuel and could have profound effects on domestic manufacturing and foreign policy," *The New York Times* stated recently. New well-paying jobs in energy-producing areas of the country are on the rise. In fact, the nascent shale gas industry already employs 600,000 workers, and North Dakota, amidst a drilling boom, has the country's lowest unemployment rate at 3%. As energy-consuming companies benefit from the reduced

cost of power and some raw materials, factory operating costs decline, a phenomenon which is attracting manufacturing (and employment) back to the U.S. As a nation, America is starting to reduce dependence on energy sourced from unstable regions of the world. Net oil imports, which peaked in 2005, have fallen to a sixteen-year *low*, according to the U.S. Energy Information Administration. Trade balances are beginning to improve, and the U.S. could even become a net *exporter* of energy and related products. Amidst the plethora of challenges our economy faces, it is worth noting that these positive developments were completely unforeseen just a few years ago.

America now controls its own natural gas supply, but that is only part of the solution to the nation's energy needs. Over the next quarter-century, renewable energy sources, including but not limited to wind, solar, and emerging bio-fuels, will increasingly drive our energy transformation. Saybrook Capital proudly installed photovoltaic solar panels on our Sag Harbor office building in 2007, and it thrills us to see our electric meter run in reverse on these glorious sunny spring days, as we "sell" power back to the local utility. The growing use of solar panels helps power plants cope with high load demands during peak times (i.e. maximum solar generation coincides with high air-conditioning use). However, our expensive technology sits dormant every night and on our all-to-frequent rainy days, emblematic of the intermittency and storage challenges that green energy faces. Furthermore, solar power that is economically viable in an environment of high utility rates and generous subsidies becomes less cost-effective when low-cost natural gas enables electricity rate reductions, like the one just enacted by the Long Island Power Authority. Inevitably these problems and imbalances will be resolved as new technologies continue to emerge and gain economies of scale, as happened in the 1850s when petroleum began to replace whale-oil (Sag Harbor's once thriving industry). Moreover, some of the most promising, while less glamorous, developments have been enhanced efficiencies: smart-grid technology, thermal insulation, and improved vehicle mileage (an ambitious agreement between the U.S. government and automakers has established a target standard of 54.5 miles per gallon by 2025). Yet it will be some time before a major reduction occurs in the worldwide use of fossil fuels, and there is little agreement on which technologies will win out. We see natural gas as a key bridge fuel for the next few decades as renewable fuels become more practical, reliable, and cost-efficient.

As with any transformative economic change there will be winners and losers, and it is crucial to invest carefully and diversify. We are bullish on the economic and societal impact of the emerging energy transformation, and we are confident that patient investors in good companies that surround the energy sector will be well rewarded.