The Long View

Investment insights

April 2013

Building on a boom: Energy is powering the U.S. renaissance

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Building on a boom

"... the U.S. and Canada are probably going to become energy independent. That could be a game-changing event for the world."

Jim Rothenberg, portfolio manager

It's been a while since the Union Tank Car Company had employees working around the clock, but they are these days. Same story at American Railcar Industries. That's because the demand for rail tankers that transport petroleum has been off the charts for the past year.

How big has the boom in oil production been for the rail industry? Last year more than 200,000 carloads of crude petroleum moved on the nation's rails, more than triple the amount in 2011.

Railroads are just one of the old-school industries that are benefiting from the U.S. shale boom in oil and gas. Steel plants, trucking fleets, electric utilities, chemical and fertilizer makers are all among the businesses being bolstered or, in some cases, revitalized by relatively inexpensive and abundant energy.

But the revolution in the nation's oil and gas industry isn't just about the old. It's about new business. "We have a lot of bottlenecks in terms of developing infrastructure that gets the energy from where it's produced to where it's needed," says portfolio manager Jim Rothenberg.

That means new business for engineering and construction firms and many other businesses that sell goods and services critical to the lengthy supply chain that supports oil and gas developments.

Portfolio manager Barry Crosthwaite says the economic and financial ripple effects from the energy boom have the potential to spread across the country and a variety of industries. "Right now, for example, much of the oil is moving by rail because we don't have pipelines built. But the pipelines are going to get built and those companies are going to participate in the growth over the next decade."

Conversely, rapid change may threaten some companies. "There's a process of creative destruction that goes on in the economy," Barry says. "Changes like this are both an opportunity and a threat to companies in the economy and our portfolios."

Barry says the key is global research aimed at finding companies with sustainable growth prospects, strong balance sheets and healthy cash flow. "You need fundamental research to do a good job of this. It's critical in understanding and anticipating these changes."

The new dynamic has set in motion a chain of events that would have been hard to imagine even a few years ago, including an end to the nation's dependency on foreign oil. "Over the next 10 years, the U.S. and Canada are probably going to become energy independent," says Jim. "That could be a game-changing event for the world."

Barry Crosthwaite
Portfolio manager
16 years of investment experience

Momentum for change

The energy boom has such broad implications for the United States that you're going to see tremendous transformations over the next decade.

Of course, the most important one is that the U.S. is moving toward energy independence, but along the way there are going to be a number of dramatic changes.

One of the biggest changes will be in transportation. Many long-haul trucks are going to convert to natural gas, and so are fleets of buses and taxis, along with delivery and waste trucks and other vehicles. That's probably going to reduce their costs, and result in a surge in the construction of service stations and other infrastructure for these vehicles.

The energy revolution has also led to a manufacturing renaissance. Because of lower input costs and increased demand, a range of companies, including chemical and fertilizer makers, steel plants and refineries are all spending billions to build out capacity. In turn, that's going to create a boom for engineering construction spending.

For investors, there will be significant opportunities, as well as risks. But I think this is all very positive for the United States.

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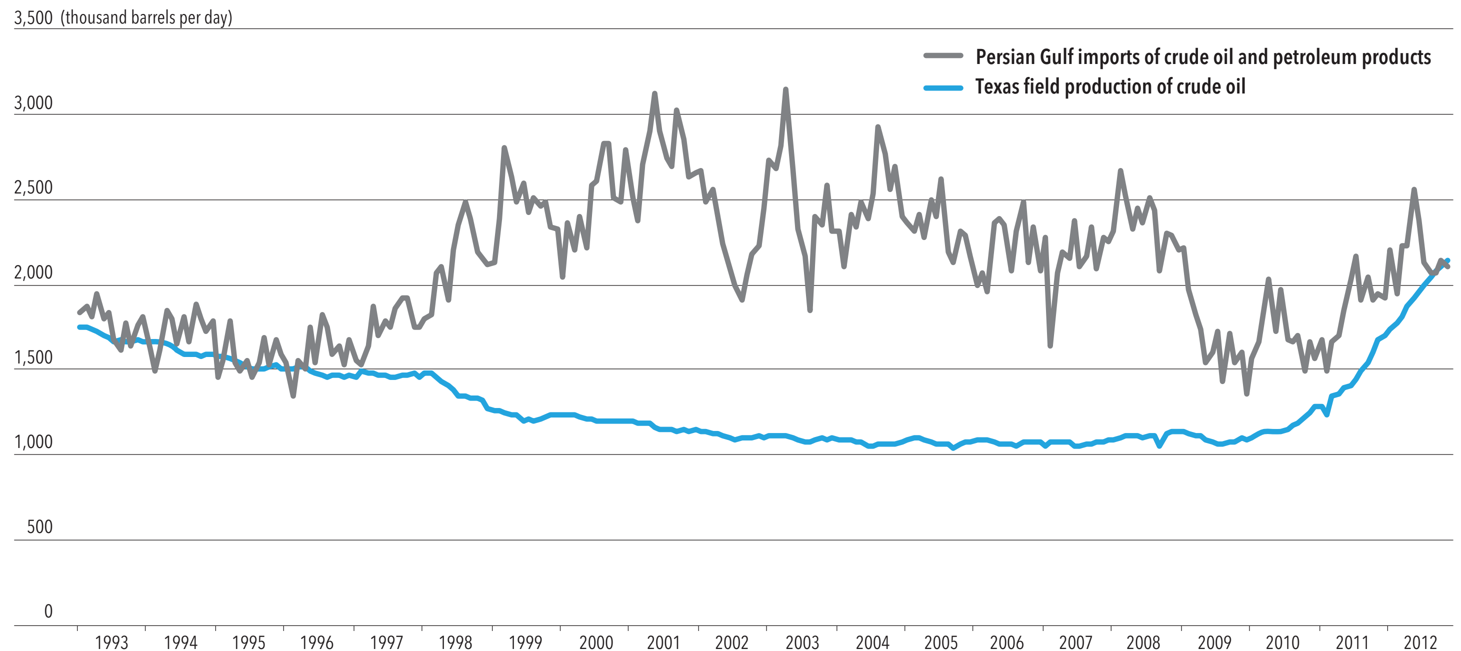
Past results are not predictive of results in future periods.

Texas tea: State's oil output has topped Persian Gulf imports

U.S. energy independence may be on the horizon

"The U.S. is going to move toward energy independence over the next decade. That's an unbelievable development due mostly to innovations in the energy industry."

Barry Crosthwaite, portfolio manager



Source: Energy Information Administration. Persian Gulf includes Bahrain, Iran, Iraq, Kuwait, Qatar, Saudi Arabia and United Arab Emirates. Data are from January 1993, when figures for Persian Gulf imports became available, through November 2012.

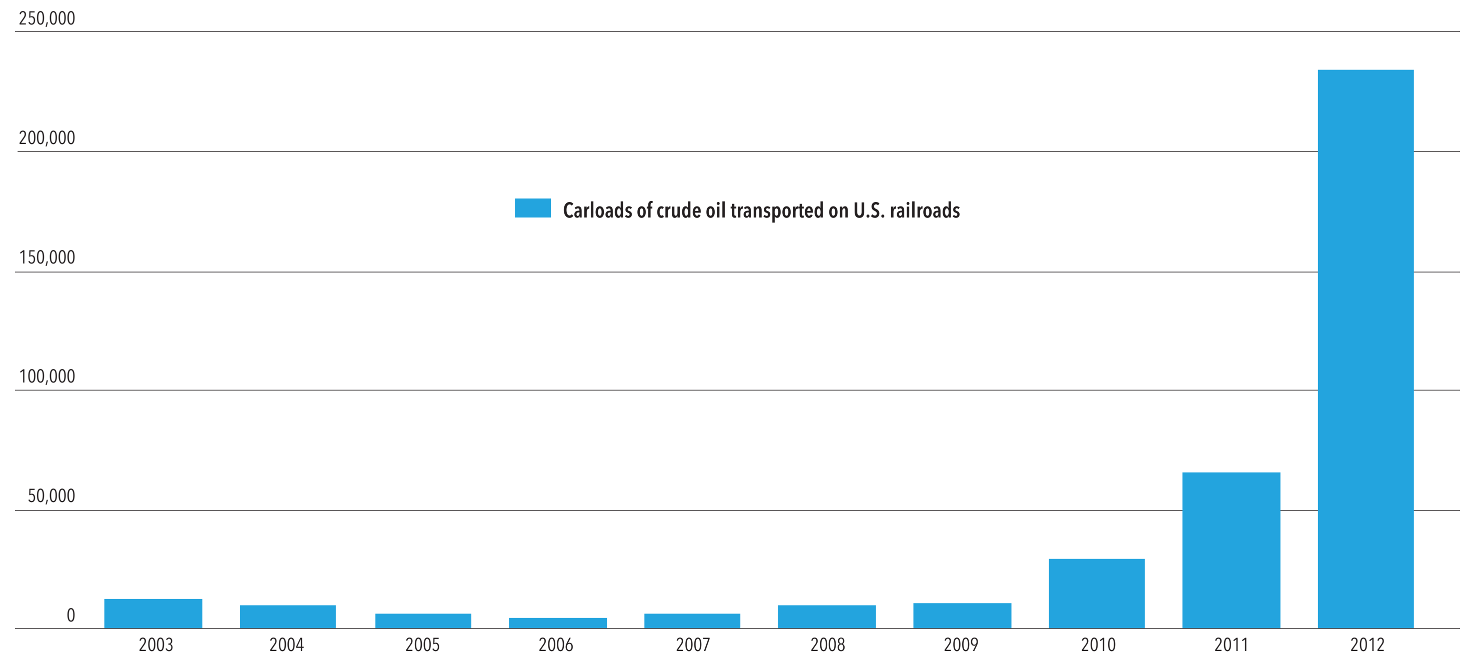
- Texas has long been known for its oil production, but now the Lone Star State is producing crude at a level not seen in years. The state's oil output in November 2012 averaged about 2.1 million barrels per day. That was slightly greater than all of the U.S. oil imports that month from the Persian Gulf countries, which includes Saudi Arabia. The last time Texas oil output matched Persian Gulf imports was 17 years ago in April 1996.
- The increase in the production of oil in Texas is just one chapter of this nation's march toward energy independence. In fact, U.S. oil production grew more in 2012 than in any year in the history of the domestic industry. Daily crude output averaged 6.4 million barrels a day. That's an increase of about 779,000 barrels a day from 2011. The U.S. Energy Information Administration predicts 2013 will be an even bigger year, with average daily production expected to jump by 900,000 barrels a day. Indeed, the U.S. is expected to surpass Saudi Arabia in crude production by 2020, according to the International Energy Agency.
- The surge is mostly due to technological breakthroughs in horizontal drilling and hydraulic fracturing, which involves pumping water, chemicals and sand at high pressures to break apart underground rock formations. The new method led to a resurgence of activity in well-established oil regions, such as Texas, where output has doubled over the last three years and reversed a 22-year decline.

Lonesome whistle? The new energy boom rides the rails

Demand for tankers is overwhelming supply as crude shipments via U.S. railroads soar

"The development of shale oil and gas could have profound implications for our industrial backbone, not only for the companies pulling the gas and oil out of the ground, but for infrastructure and transportation in the U.S."

Martin Romo, portfolio manager



Sources: American Association of Railroads (AAR), Moving Crude Petroleum by Rail, December 2012; AAR Quarterly Commodity Statistics database; and AAR website.

- The role of railroads in the United States can hardly be overstated. Since the 1820s, cities have grown up around railroads, and rail cars have moved just about everything from hogs to hobos. In some ways the nation is now returning to the days of yore, and relying once again on the iron horse to move the country's newfound energy.
- Now, rail cars are proving especially useful for moving crude from the oil fields to consumers, partly because the existing pipeline network doesn't mesh with new geography of energy production. In 2006, there were about 4,700 tanker carloads of oil shipped in the U.S. In 2011, the number jumped to about 66,000, and in 2012 the rails moved more than 200,000 carloads of crude. That's helped offset a decline in coal shipments, which remains the dominant category of carload shipments.
- In the first two weeks of January 2013, rail car manufacturers received orders for more than 2,500 new tank cars. Demand for tank cars is so high, there's a backlog of 40,000 cars on order. Phillips 66, the refining and chemical company, last year placed a $200 million order for 2,000 rail cars to transport crude from the North Dakota oil fields to its refineries on the east and west coasts of the U.S.

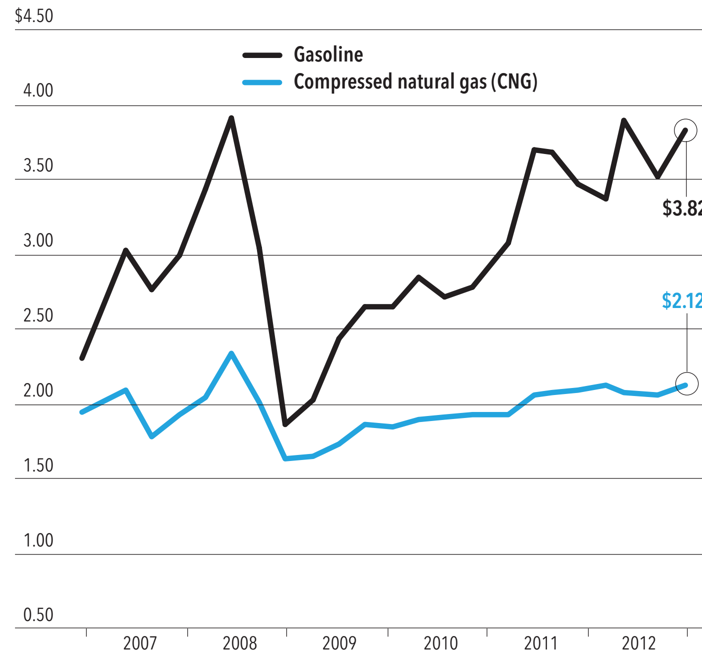
Fueling change: Some fleets converting to natural gas

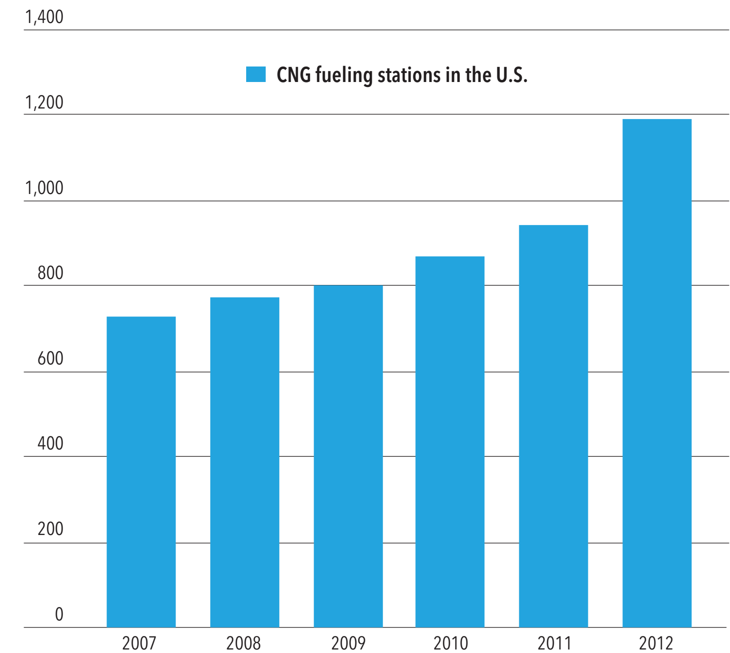
From big rigs to school buses, fleets are in transition to gas of a different kind

"Whenever you have an industry that's undergoing significant change, that creates investment opportunities. And right now the energy industry is in the midst of massive change. Natural gas, obviously, is going to be a much bigger part of the overall energy base going forward."

Brady Enright, portfolio manager

Low price has led to more stations to fill up with natural gas



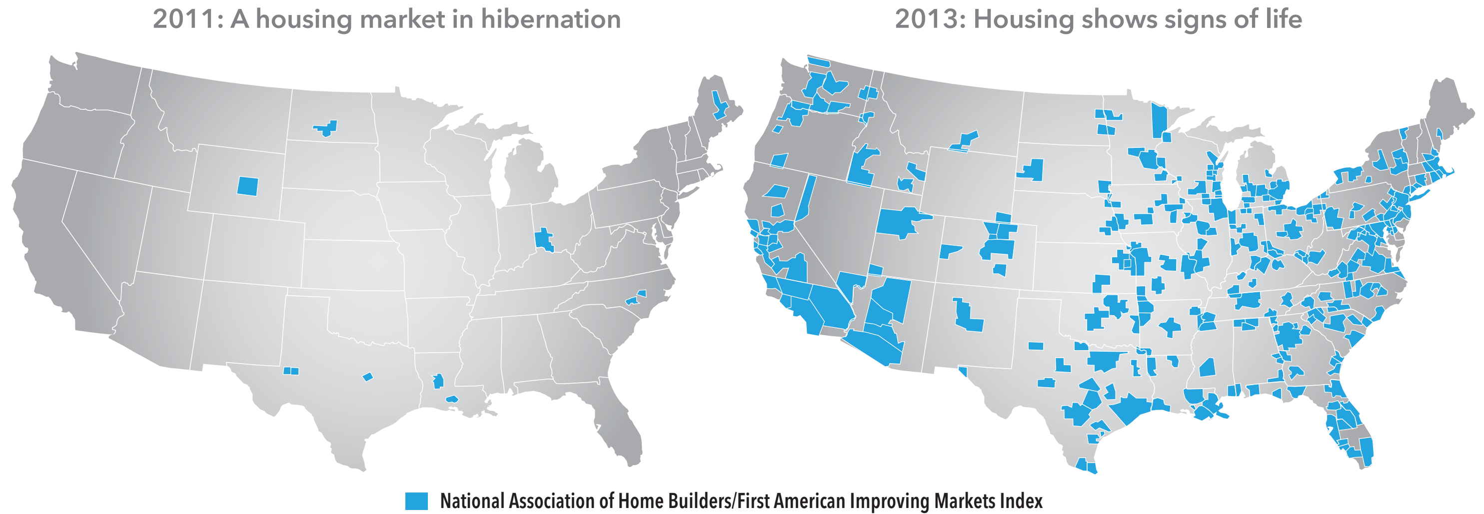


Sources: U.S. Department of Energy, Alternative Fuels Data Center; *Clean Cities Alternative Fuel Price Reports*. Cost of gasoline represents the U.S. average retail price per gallon; for CNG, it is the cost per gasoline gallon equivalent. Average fuel prices for 2012 are as of October 12. Number of fueling stations are as of December for each year.

- A number of companies across the nation are beginning to transition their truck fleets from gas and diesel to natural gas. The change might be most rapid among companies that bring their vehicles back to central refueling stations, such as waste trucks. But the trend is evident in long-haul trucking firms as well. Indeed, a "natural gas highway" is beginning to take shape across the country to serve the growing number of natural-gas powered big rigs plying the nation's interstates.
- Waste Management Inc., for example, already has a fleet of about 1,700 natural gas vehicles and plans to have about 80% of its new trucks run on compressed natural gas, or CNG. (CNG is used primarily in buses, vans, cars and some trucks, while LNG, or liquefied natural gas, is used in heavy-duty trucks). AT&T now has about 3,000 natural gas vehicles in its fleet and recently bought 1,200 natural-gas-fired cargo vans from General Motors. By 2019, AT&T expects to have 15,000 alternative fuel vehicles on the road.
- A transition is also under way at the other end of the spectrum, one that could cut fuel costs for long-haul trucking outfits. The makers of big truck engines, such as Cummins, Peterbilt, Caterpillar and Navistar, are all now building LNG engines. Navistar projects that one in three of its new engines will run on natural gas within the next few years.

From coast to coast, the housing market is gaining momentum

The number of improving markets has soared since 2011

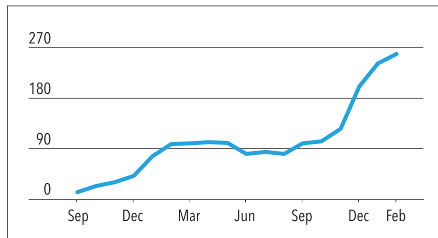


"The outlook for housing remains favorable. The National Association of Home Builders housing market index has clearly turned up, as has the pace of household formation. Nearly all indicators suggest that housing activity should continue to improve as we move through 2013."

Darrell Spence, economist

Improving Markets Index

2011		2012				2013
Sep	Dec	Mar	Jun	Sep	Dec	Feb
12	41	99	80	99	201	259



- After enduring a four-year depression, the housing industry now seems more like a tailwind than a headwind. The numbers for 2012 seem to show the U.S. housing market is recovering. Last year there were 780,000 housing starts, including both apartments and single-family homes, the highest in four years.
- That's good news for construction jobs, and although total construction employment is well below its peak, there are now about 300,000 more people employed in construction than two years ago. In addition, home prices are rising in most markets, and sales have picked up, but they are still low by historical standards. Indeed, many homeowners continue to owe more than their home is worth.
- The benefits from a housing recovery are likely to go far beyond the direct impact of spending on residential construction, or even on such secondary beneficiaries as carpet and furniture. The benefits could also show up in state and local government spending, whose revenue is tied to property values.
- The housing recovery is highly dependent on job and income growth, as well as consumer confidence. But between pent-up demand, the country's demographic profile and the multiplier effect, there may be factors now in play that bode well for the nation's economic vitality. Cheaper borrowing costs, improving property values and job gains may combine to drive gains in housing demand, a source of strength for the expansion.

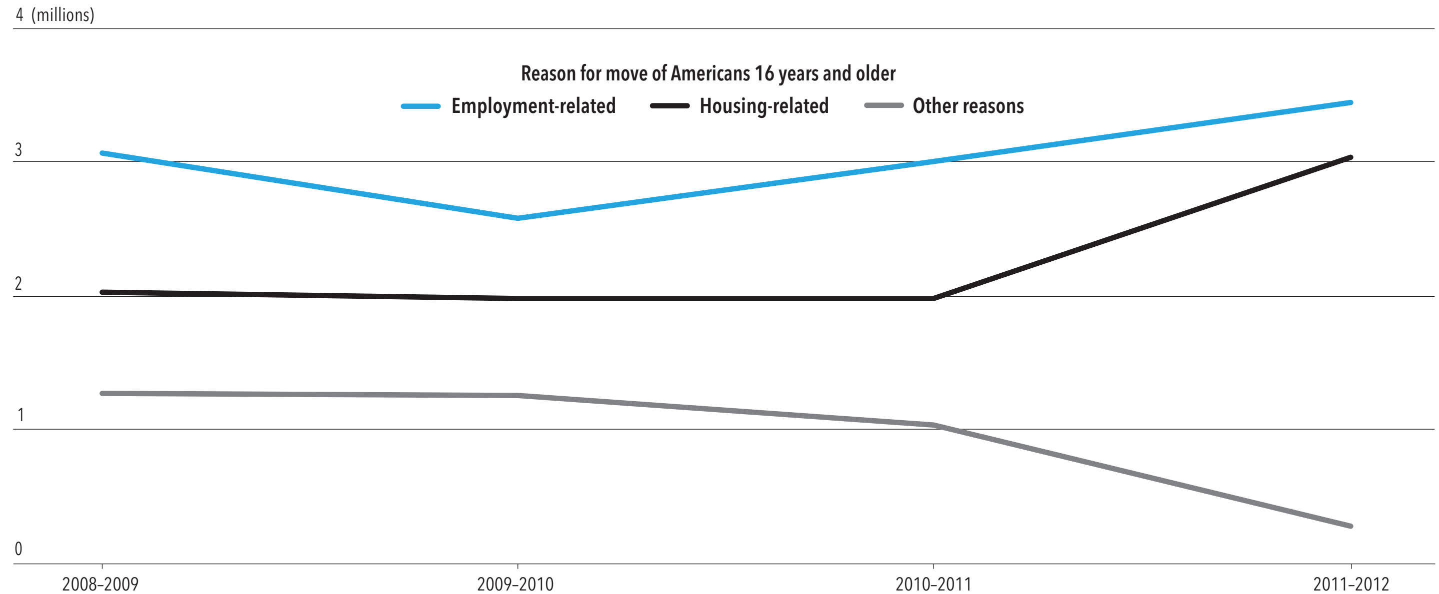
Source: National Association of Home Builders. The Improving Markets Index (IMI) is designed to track housing markets throughout the country that are showing signs of improving economic health. For a complete definition of the index, see page 12. The following markets not shown were included on the improving markets list for 2011: Anchorage and Fairbanks, Alaska; for 2013, they included: Anchorage, Alaska, and Honolulu, Hawaii.

The "lost generation" begins to find itself and move on

Americans are on the move, looking for a fresh start after the recession

"There's clearly pent-up demand in a number of areas. One of the areas I would highlight is housing, and that can be a significant driver of the economy, both directly and through indirect effects."

Chris Buchbinder, portfolio manager



Source: United States Census Bureau, Current Population Survey, Annual Social and Economic Supplement (2009, 2010, 2011 and 2012).

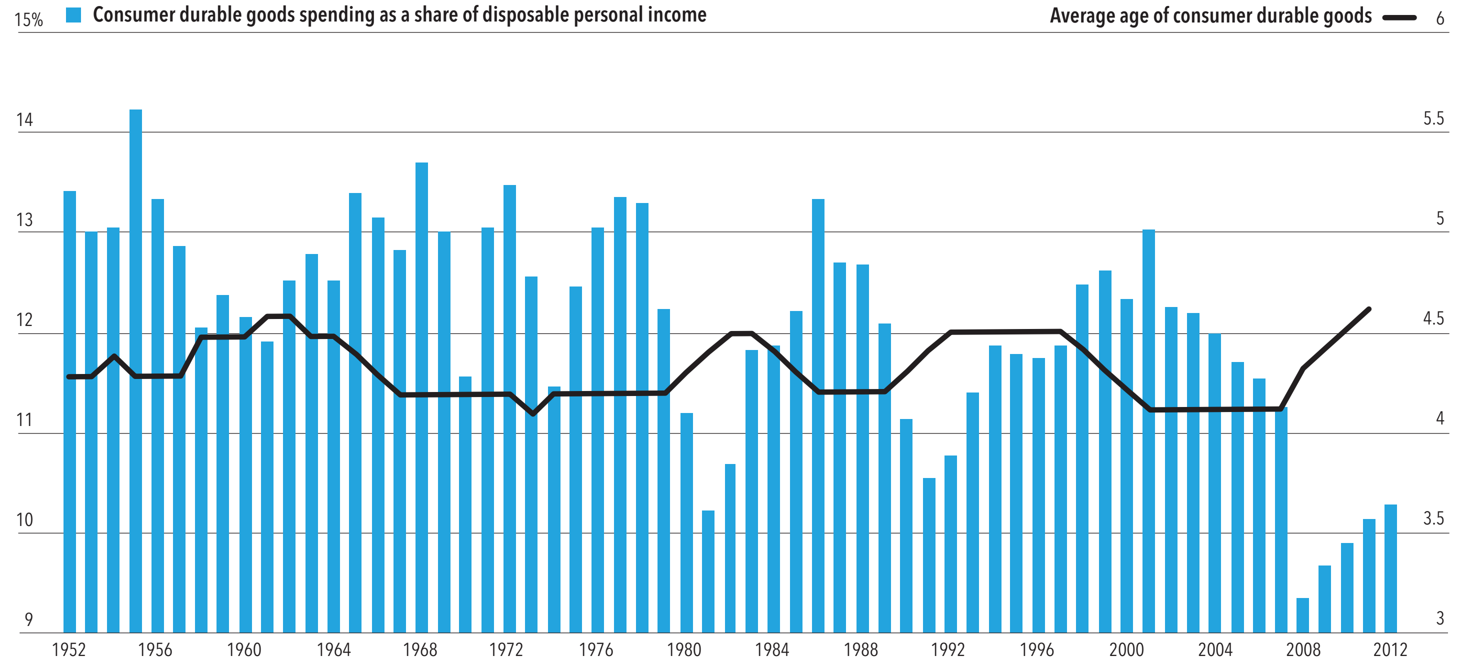
- After being stuck in place due to the Great Recession, there is increasing evidence that Americans are on the road again. The Census Bureau reports that about 3.9% of the population, or 11.8 million people, moved to a different county in 2011. That was the highest level since before the recession, and up from 3.5% in 2010 and 2009 – the lowest level since the government began keeping records in 1948.
- Pent-up demand and restlessness may explain some of the movement. Many young adults have been constrained by the weak economy and haven't been able to venture out on their own. Nearly a third of Americans between the ages of 18 to 35 were living with their parents in 2010.
- The report says that 25- to 29-year-olds were among those moving, indicating that many young people who were hampered by a sluggish economy and weak labor market were finding jobs and moving on with their lives.
- However, the 3.9% rate remains low historically, and while numbers aren't yet available for 2012, there is anecdotal evidence from moving companies that Americans continued to move. Among the states that gained population in 2011 from domestic moves – rather than from immigration or births – were Florida and Nevada, according to a separate Census survey of moves in and out of states. Both Florida and Nevada are recovering from the housing bust. Oil-boom states like North Dakota also saw gains.

Tight-fisted consumers may be ready to spend again

Consumer durable spending: A long time between big-ticket items

"Housing is on the road to recovery and house prices are rising in many places. There's certainly a regional impact to housing that will feed back through consumer goods. But housing has a multiplier effect that not only helps retailers, but the labor market and eventually the country's overall economic strength."

Rob Lovelace, portfolio manager



Sources: U.S. Department of Commerce and Empirical Research Partners (spending); Bureau of Economic Analysis (age). Data are as of December 31 for each year. Average age for 2012 is not yet available.

- Americans may soon start buying more cars, appliances and other big-ticket items because the ones they own may be starting to show their age.
- The chart displays the average age of consumer durable goods, as compiled by the Commerce department. In 2011, the average age of all goods climbed to 4.6 years, the highest since 1962. The increase was the fourth in a row, the longest streak since the Great Depression.
- The chart also shows that the percentage of disposable personal income spent on big-ticket items has been climbing since reaching a record low in 2008, although at 10.3% in 2012 the amount remains low relative to spending during the past 60 years.
- There has been further evidence of increased spending recently. Orders for durable goods rose in December 2012 for an unprecedented fourth consecutive month, indicating U.S. manufacturing probably will keep improving in 2013.
- Between machines wearing out, and Americans feeling more comfortable with spending, increased buying of durable goods may be poised to help boost the U.S. economy.

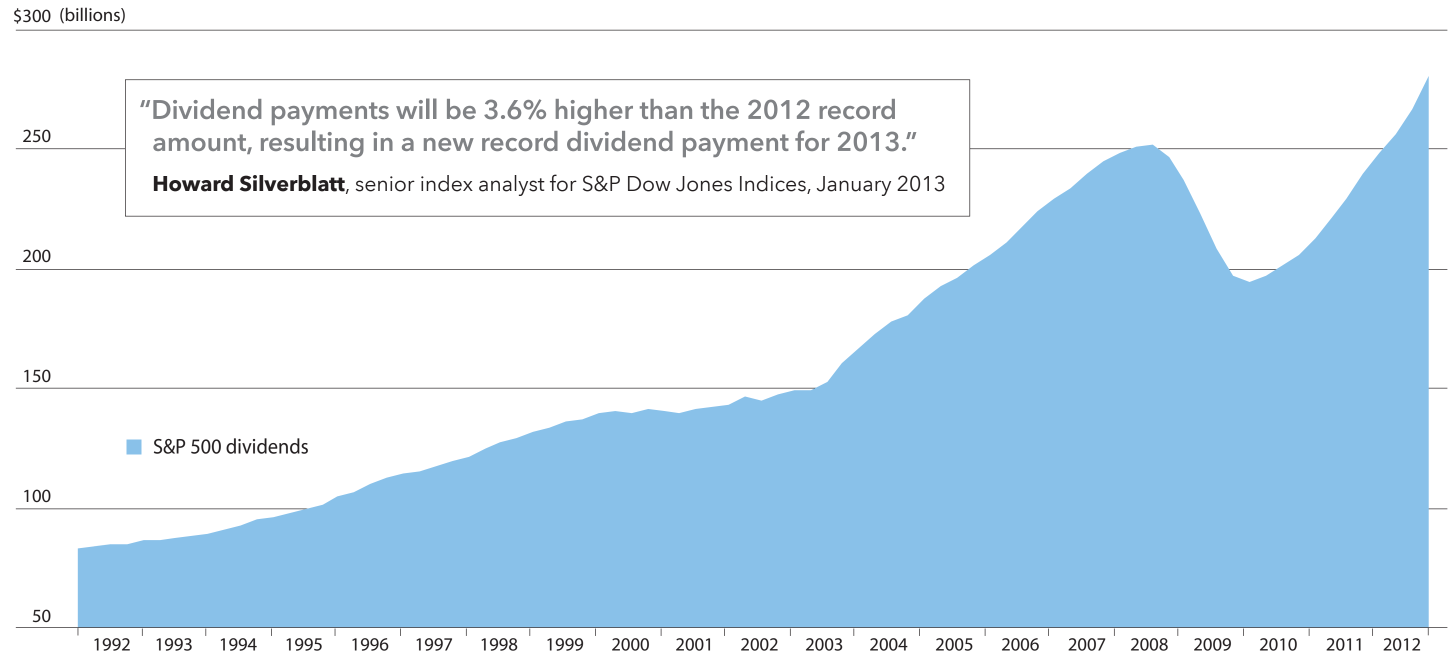
Dividend payments soared to a record in 2012

Income conundrum

Another record may be set in 2013

"Right now the payout ratio in the United States is near a historic low. There's a lot of room for managements to pay more of their earnings in dividends. I think a lot of companies are coming around to that conclusion."

Jim Lovelace, portfolio manager



Sources: Standard & Poor's and Yardeni Research, Inc. Data represent four-quarter sums.

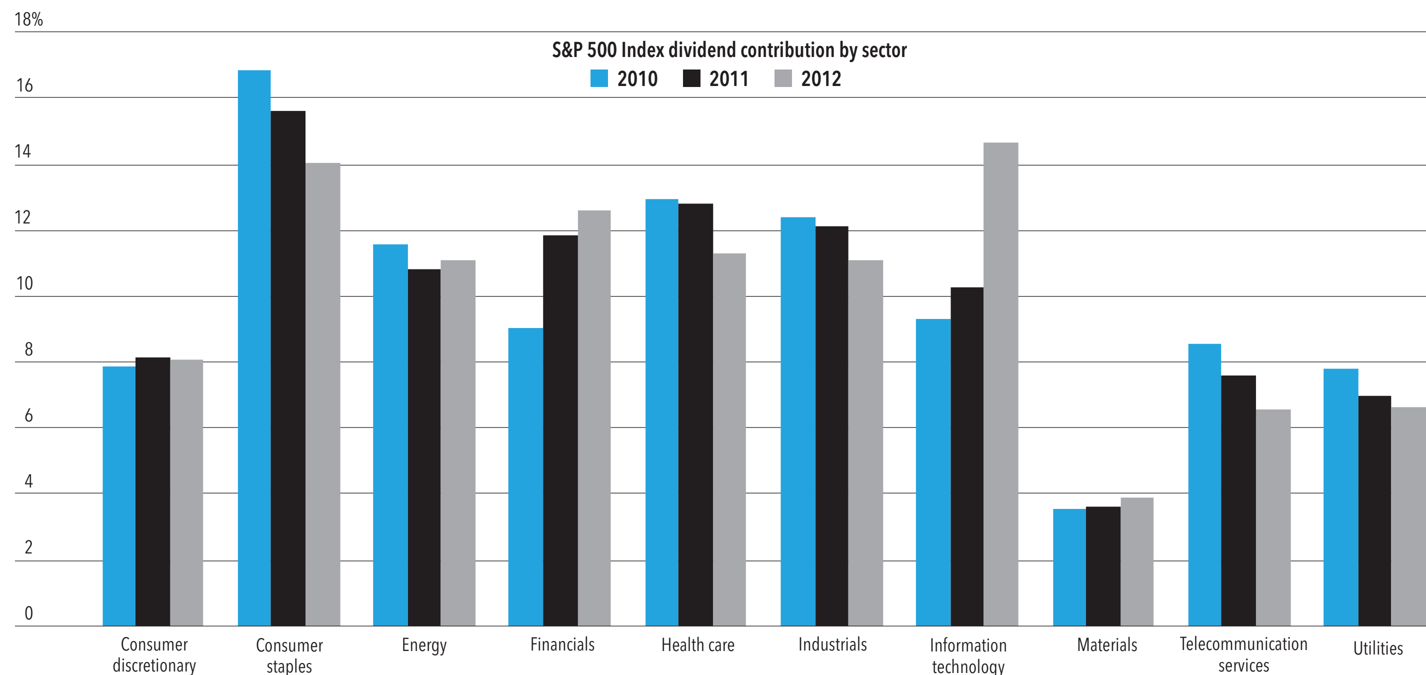
- S&P 500 companies paid out a record $281.5 billion in dividends last year. The total marked a 17.1% increase from the previous year and a 13.6% advance from the all-time high set in 2008.
- Special dividends announced in the fourth quarter of 2012 — as companies and investors contemplated changes in the tax code — contributed to the record payouts. Corporations announced more special dividends — or one-time payments that occur outside the normal payout cycle — in December 2012 than in any other December since at least 1955.
- Despite those special circumstances, dividends are projected to increase in 2013. Indeed, the recent payout ratio of about 36% is well below its long-term average of nearly 50%, which suggests the potential for S&P companies to increase dividend payments, especially given the level of corporate profits and abundance of cash on the balance sheets of many companies. Indeed, 2013 seems to be picking up where 2012 left off. After paying $47 billion more in dividends in 2012 than the year before, S&P 500 companies increased dividend payments by $9.6 billion during the first two months of 2013.

Tech companies get on board the dividend bandwagon

The dividend landscape shifts as information technology tops all dividend payers

"I especially like to see dividend growth because that means the company is growing, they are doing the right thing and returning capital to shareholders instead of building an empire out of the company."

Joyce Gordon, portfolio manager



- The dividend landscape has shifted. Once the province of utilities and consumer product companies, dividends last year came from a sector that once disdained paying dividends to shareholders.
- In a first for the index, the information technology companies in the S&P 500 paid more in dividends last year than companies in any other sector.
- The S&P reported that in 2012 the technology sector accounted for 14.7% of all dividends paid to investors, up from 10.3% in 2011 and from about 5% in 2004. The tech sectors supplanted the consumer staples sector, which has paid the most dividends for the previous three years.
- Tech's rise to the top was largely because of the decision by Apple, maker of the iPhone and other electronic devices, to begin paying dividends last year. The company, among the largest in the world by market cap, announced plans in March to begin making payouts. The company had been public for more than three decades without paying a dividend. Four other technology companies in the index – all but one of which had been public for more than two decades without paying a dividend – later joined in making payments to shareholders.
- The transition highlights the importance of research. Dividend investing is about looking ahead, selecting securities that may initiate a dividend, or have the potential to grow their dividend and keep those payments coming.

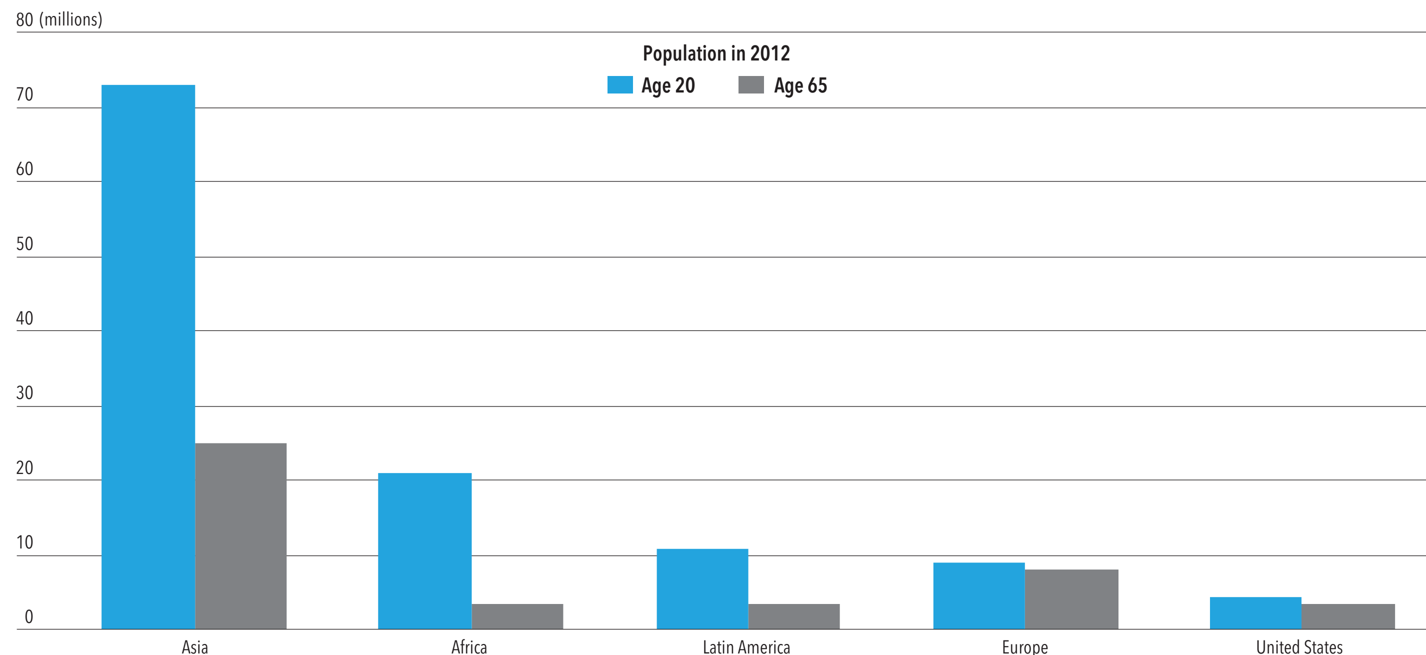
Source: Standard & Poor's.

Youth movement may represent opportunity in developing world

One benefit of this demographic tailwind: a robust working-age population

"Developing countries have a much younger population, much bigger potential labor forces and also the opportunity to grow faster. I think long-term investors should have a realistic exposure to emerging countries and markets."

Jim Rothenberg, portfolio manager



Source: United States Census Bureau. Latin America includes the Caribbean. Population estimates/projections are as of July 1.

- Much of the developing world may benefit from a demographic tailwind during the coming decades. The chart shows that many emerging countries have a relatively young population, or a profile in which much of the population falls in the most productive age groups. For example, in Asia, about 72 million turned 20 last year, while only about 25 million turned 65.
- For many of those countries, the numbers translate into a robust working-age population over the coming decades. In India, for example, about 150 million people will enter the workforce over the next decade. That's about the present size of the entire U.S. workforce. Many developing economies, including China, are expected to continue experiencing growth at a faster rate than the global average.
- Countries in Latin America may also experience a youth movement that could make them an attractive location for companies looking for a labor force, particularly in the manufacturing sector.
- In addition, the population bulges represent the potential for significantly increased consumption of products and services ranging from household goods to health care.
- Between the age of the population and their increased spending power, developing countries probably will drive demand for products, and provide opportunities for growth in a broad range of sectors and industries.

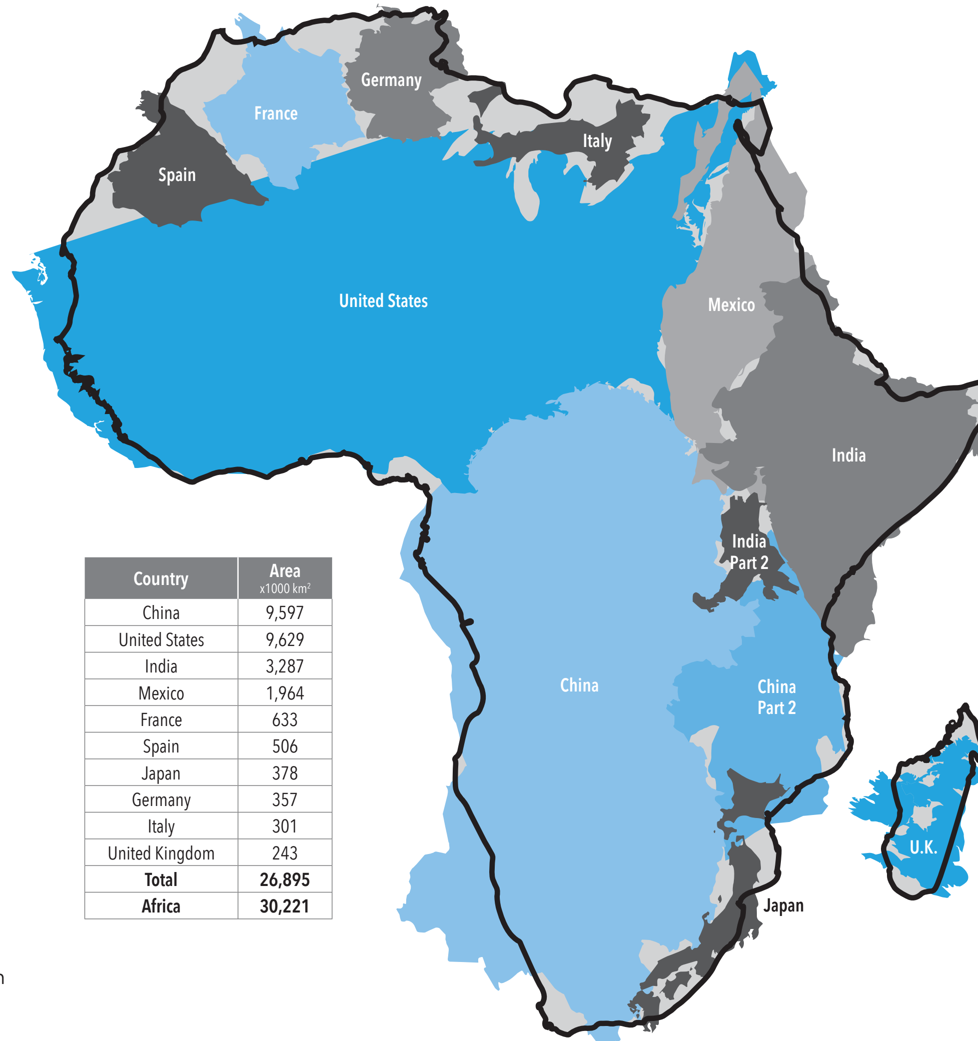
Next wave of growth

Vast and challenging, Africa is on the rise

Many African economies are growing, and a consumer class is evolving

"When you think of the emerging middle class, Africa might not be the first area that comes to mind, but we are finding some very compelling opportunities there."

Chris Thomsen, portfolio manager



Country	Area x1000 km²
China	9,597
United States	9,629
India	3,287
Mexico	1,964
France	633
Spain	506
Japan	378
Germany	357
Italy	301
United Kingdom	243
Total	**26,895**
Africa	**30,221**

Sources: *Abundance: The Future Is Better Than You Think*, 2012, Peter H. Diamandis and Steven Kotler; Kai Krause; and Creative Commons. Some countries are cut and rotated.

- Sub-Saharan Africa is home to nearly 900 million people, many of whom live in poverty and face hardships in their daily lives that are among the most daunting in the world. But amid the many problems that beset the region, the economies of numerous African countries have been growing.
- One element of opportunity in Africa, and a source of challenge, is simply its size. The chart shows that the continent is larger than the U.S., China, India, Japan and all of Europe combined. In its October 2012 *World Economic Outlook*, the International Monetary Fund reported that economic activity in sub-Saharan Africa has been expanding by 5% or more a year throughout the past decade, except during the global downturn in 2008-09. Many of the countries are rich in natural resources, and high commodity prices played a role in supporting faster growth.
- Many of the region's countries that aren't rich in resources have also increased their growth rate, mainly due to rapidly expanding services. For example, the Shoprite Group of Companies, Africa's largest food retailer, has expanded well beyond its home base in South Africa and now has supermarkets in 17 countries, from Angola to Zimbabwe. Naspers Ltd., Africa's biggest media group, recently reported pay-television service expanded to more than 6 million homes. The growth is partly due to people moving into the middle class outside of South Africa.

The National Association of Home Builders (NAHB)/First American Improving Markets Index (IMI) measures three sets of independent monthly data to get a mark on the top improving metropolitan statistical areas. The three indicators analyzed are: (1) employment growth from the Bureau of Labor Statistics; (2) housing price appreciation from Freddie Mac; and (3) single-family housing permit growth from the U.S. Census Bureau. The NAHB uses the latest available data from these sources to generate a list of improving markets. A metropolitan area must see improvement in all three measures for at least six consecutive months following those measures' respective troughs before being included on the improving markets list.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing. Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility, as more fully described in the prospectus. These risks may be heightened in connection with investments in developing countries. The statements in *The Long View* are the opinions and beliefs of the speaker expressed when the commentary was made and are not intended to represent that person's opinions and beliefs at any other time.

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