A TECTONIC SHIFT

December 10, 2016

Our energy sector Fund's outperformance in November was, we believe, driven by two surprising events: Donald Trump winning the election and OPEC agreeing to cut oil production. The sector, as a whole, surged as investors weighted the prospects of a balanced oil market, Trump's focus on domestic infrastructure, and most importantly a less punitive regulatory environment for the industry.

We note that the Trump win appears to provide real momentum for the energy space. Trump is a promoter of U.S. energy independence. He is considering opening more federal land for drilling and easing the regulatory environment. This would be highly beneficial for the Master Limited Partnerships (MLPs) which have been subject to unprecedented barriers from government agencies in regards to pipeline permits i.e. Constitution, Northeast Energy Direct, Keystone, and DAPL. While the Obama administration continues to put up obstacles for the deployment of hydrocarbon pipelines, Donald Trump contends that this policy will be reversed as soon as he takes office. Energy Transfer's Dakota Access Pipeline (DAPL) seems to have taken on a life of its own. The Army Corp of Engineers reversed their own approval by blocking the completion of the pipeline which is 85% constructed. We believe this could be one of Trump's signature moves as soon as he takes office and would be a tectonic shift for the energy industry. We have met or spoken with many energy management teams post-election and the mood is strikingly positive as reflected in the theme "back to business".

On November 30th, OPEC announced its first major oil production cut in over 8 years. Specifically, agreeing to reduce their oil output by 1.2 million barrels by January 2017. Additionally, as we write, non-OPEC countries including Russia have agreed to reduce oil output by 558,000 barrels per day. These events resulted in over a 10% increase in the oil price. While compliance will be questioned, we believe this was a critical move for the Saudis who are struggling to fund internal social programs and also plan on bringing some part of Saudi Aramco public. Importantly, this accelerates likely further oil market tightening and higher prices in 2017. While this is a positive for the entire energy industry, we believe the Master Limited Partnerships (MLPs) could end up being the biggest winners. Currently, many MLPs have underutilized capacity in their pipelines, as producers either reduced production in certain areas or pipelines were completed during the downturn. This has resulted in MLPs having significant operational leverage at this point in the cycle. As drilling activity accelerates and volumes come back, the cash flows should grow with little to no capital employed. Importantly, we believe the companies are getting little to no credit for a potential windfall in cash flow. For example, Plains All America has quantified about $1 billion of incremental cash flow for an uptick in volumes on their pipes. This is meaningful and we recently added PAA to the portfolio.

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November turned out to be quite an eventful month and, as mentioned, we believe our energy fund's portfolio is not given adequate credit, especially in light of its overweight allocation of MLPs and therefore is very well positioned. We will pay strict attention to OPEC's production numbers, but are hopeful the Saudi's can police the cartel. Higher oil prices should lead to incremental shale production while a friendlier regulatory environment should be welcomed by investors.