# MANAGING MARKET RISK

With their flexible investment strategies, hedge funds are attracting more investor dollars, sellside analysis and SEC scrutiny.

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**Excerpted from**

Oil and Gas Investor

**June 2006**


***Dan Tulis, who handles the $20-million Elco Select Fund, says that being invested across the entire energy sector affords the fund the ability to achieve steady investment performance.***

**Hedging its bets**

A distinctly different approach to investing in the energy sector is offered by Dan Tulis, New York-based managing director and senior portfolio manager for the $20-million Elco Select Fund. This hedge fund resides within Elco Management Co. LLC, which handles an aggregate $155 million of investments, including the $15-million, long-only Elco Energy Fund.

"We invest across the entire energy sector, from E&P and oil-service stocks through midstream plays, utilities and companies engaged in the construction of energy infrastructure," says Tulis, formerly a Smith Barney sellside analyst. "Since energy is, by definition, volatile, this approach is much more risk-averse since it has countercyclical components, that is, one subsector may do well at a given point in a cycle, offsetting the less positive results of another that may be out of favor. This affords us the ability to achieve more steady investment performance."

After fees, the long/short fund produced gains of 30.11% in 2003, 19.25% in 2004 and 18.62% in 2005. But these returns weren't just the result of being invested across the entire energy spectrum. They also arose from knowing when to shift weightings from one subsector to another.

"We started out 2003 heavily involved in the E&P sector in companies like Devon Energy, Chesapeake Energy and EnCana, and combined that with aggressive investment in the merchant-energy sector, in names like The Williams Cos. and AES Corp.—companies that we felt had the best opportunity for recovery after the Enron collapse," he explains.

But as time wore on and upstream cash flows rose significantly, it became apparent that E&P companies and the major integrated oils would be stepping up spending and that the oil-service sector was the place to be.

"So we shifted our money first into land drillers such as Nabors, Patterson-UTI and Grey Wolf, later into jackup drillers like Ensco and Noble Corp., then finally in late 2004 into deepwater drillers Transocean, GlobalSantaFe and Rowan Cos."

Moves like these helped Elco Select Fund last year to more than offset the disappointing investment results it experienced in the flat master limited partnership (MLP) sector.

"However, if interest rates ease later this year, then midstream MLPs like Enterprise Products and Energy Transfer Partners have the opportunity to grow distributions by 8% to 10%," says Tulis. "During the past 10 years, MLPs have been the best-performing asset class in the energy sector, with average annual rates of return exceeding 20%."

The portfolio manager is also sanguine in his outlook for gas producers like Chesapeake and EnCana. "The futures market is telling us that gas prices, recently around $7, are likely to be at least $10 this time next year."

Still, Tulis notes that Elco Select Fund will remain heavily invested in the service sector—more so than in E&P stocks—and will buy on any corrections in the group. This includes not just drillers but service providers like Halliburton, Schlumberger, National Oilwell Varco and Grant Prideco.

"The whole energy sector complex now looks to be in more of a tighter supply position than it has been in the past 25 to 30 years—and the idea that energy could be a good sector to invest in long term has caught the eye of a lot of investors," he says.

"That, in turn, has created the need for more investment vehicles. Given the hedge-fund structure, there are several investment approaches investors can use within it that simply aren't available in the public market." □