CREDO WEALTH

Scorched Oil Tactics

Following the extended rout of oil over the past six months and the media frenzy surrounding it, investors would do well to remember the dictum of 19th Century French economist Frédéric Bastiat: in the sphere of economics there is always *"ce qu'on voit et ce qu'on ne voit pas"* – what we see and what we don't see. We may see the rise of shale in the US, and OPEC's refusal to cut production, but the impact of high shale depletion rates, the end of cheap money for shale producers, and budget breakeven levels for OPEC members are hard to quantify. As ever, the law of unintended consequences will likely apply.

Shale's ascent has been rapid: since 2007 the vast majority of the increase in global oil supply has come from this source. Yet there is cause to doubt the nascent revolution: the EIA forecasts that US tight oil production will peak before the decade is out. As oil has slumped, much debate has surrounded the marginal cost of extraction for shale producers. That is, at what price level does extraction become uneconomical? There is no clear answer to this question, not least since numerous companies have prudently hedged their exposure.

The shale boom has been fuelled by high yield debt, $650bn of which has been issued in the oil and gas industry since 2011 alone. Yet the cheap money has long gone: while in June of last year companies could borrow at only ~5.5%, that figure has since doubled to ~11%. For highly levered producers, such levels are unsustainable. Shale's Achilles' heel, however, lies in depletion rates. After 3 years a typical well's production will have declined by 80-90%. A conventional well, by contrast, would only decline by ~16%. Thus, in order to maintain production, producers must repeatedly drill anew, eroding their cash flows.

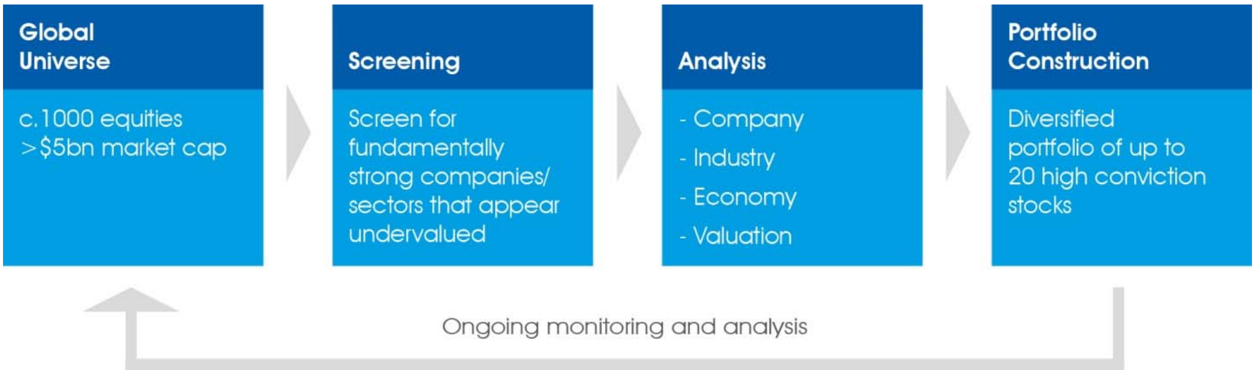
Yet shale producers aren't the only ones smarting from the slide in oil prices. At current levels, large swathes of conventional oil fields are also unprofitable. Most OPEC members' national budgets are predicated on higher oil prices, in some cases even up to $100. Current price levels will test their mettle: if OPEC refuse to cut production, many of their members will face running a budget deficit. While Saudi Arabia's extensive foreign exchange reserves can insulate them from this, others such as Nigeria aren't so fortunate. With oil revenues accounting for roughly 70% of the economy, the currency has dropped over 7% since OPEC's November announcement. In the face of decimated oil revenues, the threat of political instability looms. We need only look to Russia's recent woes to gauge the destabilising effect low oil prices can have.

In true Bastiat style, what we do not see today, hindsight will illuminate tomorrow. Today the market is over-supplied, and shale producers are increasingly stretched. Industry consolidation, CAPEX cuts, and even bankruptcies are within the bounds of probability. Yet with the burden of costs being upfront, and wells already drilled, production may well rise throughout 2015. Though we may not have seen the bottom of the market, we do not see this as a structural change. With a war of attrition raging, supply will eventually fall. As the oil price has ticked up this month, perhaps the tide is already turning. In the meantime, however, such Fabian tactics have proven a boon to the value investor. While we cannot see how the spoils will be divided, we can see opportunity to be had.

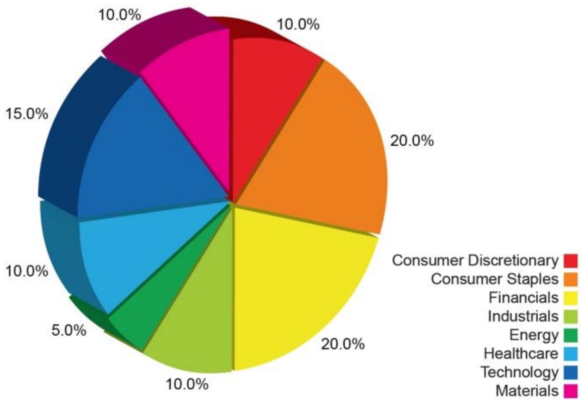
BESTIDEASPORTFOLIO

The Credo Best Ideas Portfolio is a diversified portfolio (not a fund) of global equities which we believe to be well-positioned to outperform the wider equity market over the longer term. The portfolio has a bias towards developed market, large capitalisation stocks. Our aim is to generate sustainable excess returns versus global market indices through careful stock selection.

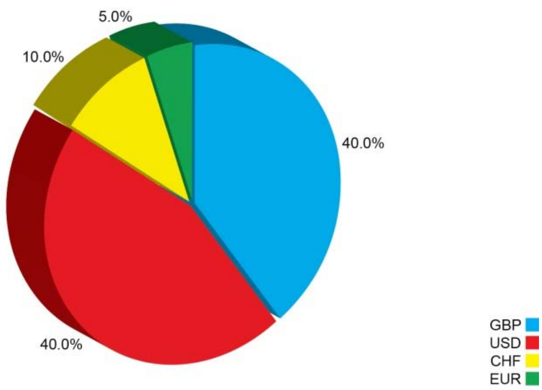
Investment Process



Sector Allocation



Currency Allocation



Performance / Stats[1]

	Trailing 12 Month P/E	12 Month Forward P/E	Dividend Yield	Return Since Inception (14/04/2011)[2]	Annualised Return Since Inception
Best Ideas Portfolio	14.2x	14.7x	3.0%	56.4%	12.5%
MSCI World Index	17.2x	16.2x	2.6%	47.1%	10.7%

(1) Source: Bloomberg pricing as of 30/01/2015 close.
(2) Performance figures are based on a notional portfolio, denominated in pound sterling, designed to track the holdings of the Credo Best Ideas Portfolio. Portfolio incorporates all additions and removals. Portfolio may not be fully invested at a point in time and therefore can hold a portion of assets in cash. Performance is calculated before any fees (which can vary depending on the level of service) but includes net dividends, reinvested. Following additions or removals, each holding is rebalanced to a 5% weighting.

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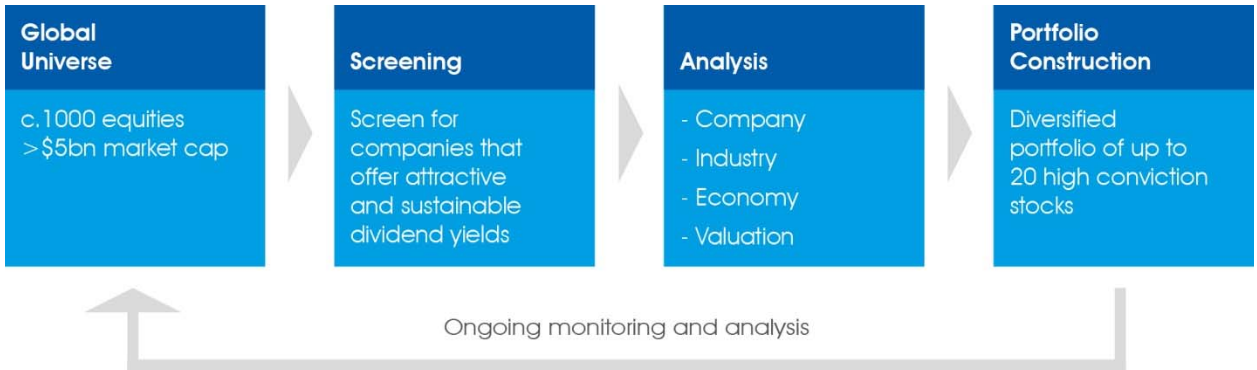
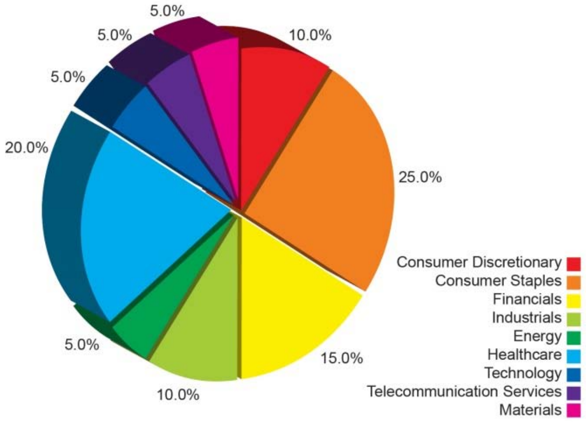
DIVIDENDGROWTHPORTFOLIO

The Credo Dividend Growth Portfolio is a diversified portfolio (not a fund) of global equities that has an objective to provide investors with a sustainable and growing income stream through dividends and share buybacks. We focus on companies that pay attractive dividend yields, with an ability to sustain and grow these over the long term. The portfolio has a bias towards developed market, large capitalisation stocks. Our aim is to generate a total return in excess of the MSCI World.

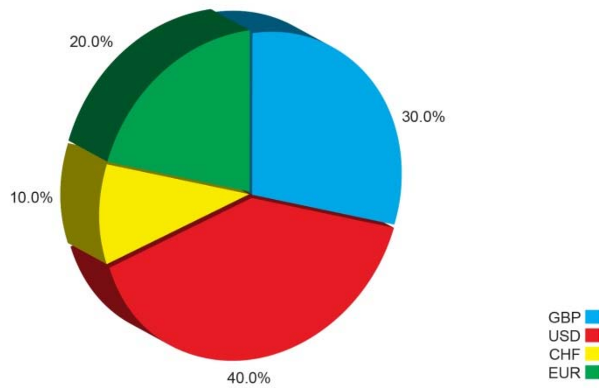
Investment Process



Sector Allocation



Currency Allocation



Performance / Stats[1]

	Trailing 12 Month P/E	12 Month Forward P/E	Dividend Yield	Return Since Inception (28/12/2012)[2]	Annualised Return Since Inception
Dividend Growth Portfolio	14.9x	14.8x	3.7%	37.4%	16.4%
MSCI World Index	17.2x	16.2x	2.6%	39.9%	17.4%

(1) Source: Bloomberg pricing as of 30/01/2015 close.
(2) Performance figures are based on a notional portfolio, denominated in pound sterling, designed to track the holdings of the Credo Dividend Growth Portfolio. Portfolio incorporates all additions and removals. Portfolio may not be fully invested at a point in time and therefore can hold a portion of assets in cash. Performance is calculated before any fees (which can vary depending on the level of service) but includes net dividends, reinvested. Following additions or removals, each holding is rebalanced to a 5% weighting.

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Performance figures are based on notional portfolios, denominated in pound sterling, designed to track the holdings of the Credo Best Ideas and Dividend Growth Portfolios. The portfolios incorporate all additions and removals and may not be fully invested at a point in time and therefore, can hold a portion of assets in cash. Performance is calculated before any fees (which can vary depending on the level of service) but includes gross dividends, not reinvested.

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