

The Fast Flowing Energy Stream

In a world where oil supply is tight, demand is rising, and OPEC plays a big role in pricing, it's hardly surprising that investors are benefiting from the strong surge in energy prices. Tim Guinness, the manager of the Guinness Atkinson global energy fund, believes that the big picture makes this trend durable for the years to come. He manages a portfolio of 28 equally weighted stocks with strong discipline and a belief that the run up is not over yet.

Q: What is your investment philosophy? What is the big picture that you're trying to take advantage of?

A: I'm trying to offer a way to invest in a strong, secular, upward trend in energy prices that's likely to continue for years. We've been living in a world where oil, adjusted for inflation, traded at an average price of about \$57 a barrel between 1974 and 1985, and then for eighteen years, it traded at around \$25 a barrel on average. Then in 2003 it averaged \$35 a barrel, in 2004 \$42 a barrel, and in 2005 \$57 a barrel. Now the price stands at \$70 or more.

My strongly held view is that this represents a decisive break with the past and a move in energy prices that will take oil up to over \$100 a barrel at some point in the next ten years. It's difficult to project the time frame as oil is a very volatile commodity but, in the long run, it is going to trend up and bring substantial returns to investors in oil and gas companies.

Behind investing in energy, and particularly in oil, there are three factors that are equally important - supply, demand, and OPEC. Since 2000, China, India, and other emerging Asian countries have been in a phase of economic

growth that leads to strong increase in energy demand. I believe that Asia, as a whole, is going to produce an extra demand of about 20 million barrels a day over the next 15 years..

On the other hand, the supply outside of OPEC is hard to grow because the areas of North America and North Sea are mature areas, well over their peak, and declining. Russia, which has been an important source of non-OPEC supply in the last five years, will peak out soon. The Caspian area although some big fields are coming on stream soon is not living up to its promise. West Africa is growing usefully but it's not a stable area politically. Overall, including all the extra sources like West Africa, Russia, Caspian, Brazil, and Canada, the supply seems insufficient to compensate for the declining maturer basins and the strong surge in demand from Asia.

The third factor, the behaviour of OPEC. They have no conceivable reason to sell oil at anything less than the best price that doesn't send the world spiraling into recession. I have no doubts that OPEC will defend vigorously a floor of about \$50. That's an extremely attractive situation because we've got a strong medium and long-term supply and demand

FUND FACTS

Symbol	GAGEX
Website	www.gafunds.com
Address	Guinness Atkinson Asset Management, Inc. 2155 Oxnard St, Suite 750 Woodland Hills, CA 91367
Tel. No.	800-915-6566
Inception	6/30/2004

PORTFOLIO

Total Net Assets *	\$94.5
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	89%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$5,000
Min Subsequent Investment	\$250
Min Initial IRA Investment	\$1,000

RISK (AGAINST S&P 500 - 3 YEARS)

Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. WILSHIRE 5000

	GAGEX	Index
1 Mo. (Cum.)	1.07%	0.19%
3 Mo. (Cum.)	0.70%	3.60%
1 Year (Ann.)	31.13%	28.26%

RETURNS VS. S&P 500

	GAGEX	Index
1 Mo. (Cum.)	1.07%	3.44%
3 Mo. (Cum.)	0.70%	2.15%
1 Year (Ann.)	31.13%	5.38%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee **	1.00%
Total Expense Ratio	1.45%

PORTFOLIO MANAGER

Tim Guinness	Jun-2004
Edmund Harris	Jun-2004

* millions ** within 1 month after purchase

Data through: 7/31/2006

Source: Company Documents; Lipper



position underpinned with this floor.

Currently oil is increasingly a transportation fuel, which has been displaced from electricity generation and home heating by nuclear and natural gas energy. In the 70s, oil demand dropped because it was partially displaced, but now it is much harder to do that. In transportation the displacement of oil based fuels - gasoline, diesel, or jet fuel - is much harder. There is plenty of talk about bio-fuels, hydrogen economy, or compressed natural gas, but these are pretty long-term projects. Their initial run isn't going to dent the demand for oil much.

Natural gas prices are also rising. Historically, gas traded at a discount to oil because it was in the wrong place. Gas is difficult to transport without pipelines or without LNG infrastructure. But for quite a long time, gas has been a very attractive fuel as a cleaner and cheaper source of energy. And over the last thirty years, there has been an ever-growing pipeline system and LNG infrastructure. This means that gas becomes a much more global commodity and is being increasingly priced no longer at a discount but on a btu equivalent basis to oil.

Principally, I'm about investing in companies that are going to benefit from the upward trend in the price of those two commodities, oil and gas.

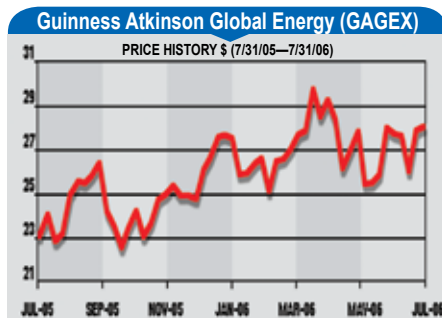
Q: What are the important elements of your research process?

A: I try to study carefully all the important drivers of supply and demand. For example geological prospectivity, availability/terms of exploration or production licences, taxation policies, technological advances, political risks, economic growth and energy consumption trends in countries around the world. Projecting future oil and gas demand and supply and OPEC behaviour are central to this activity.

I also look at the level of inventories of oil and gas because I want to have a view of what might happen in the short run. When the world is operating increasingly near full capacity, participants are going to choose voluntarily to hold

higher oil stocks because they will be worried about the effect of disruptions. In the past, if two million barrels a day of Nigerian oil was closed, you could turn to Venezuela to replace it. These options are being closed off as we get closer to full capacity everywhere. Inventories have drifted up from 52 to 54 days supply. If we go on in this tight world, inventories may have to rise back up to over 60 days.

Another thing is the level of speculative investment exposure to the commodity. Current non commercial long futures positions on Nymex are high. When these positions unwind, you might get a move in oil price of maybe \$5 to \$7. You wouldn't want to be surprised by that. I also monitor closely the flows into commodity funds with energy exposure (ETFs etc) - a new factor - and where changes in the size and direction are likely to be increasingly important.



Finally events are an important factor. It might be a disturbance in Nigeria, fear of US intervention in Iran, or hurricanes. Investing in this industry requires keeping your eye open for such events. I also follow what is happening to other competing sources of supply (coal, biofuels, nuclear, wind etc) both as the future for investment in some of those areas is rosy and because of the possible impact on the oil and gas business - our main focus.

Q: How do you capture all these macro trends and turn them into a day-to-day investing process?

A: My philosophy is to steer my canoe into the fastest-flowing part of the

stream. First, I go through my portfolio to select the sub-sectors, the geographic areas, or the market-cap sizes that offer most value at any one moment in time.

Thus I think about the relative valuation of large integrated oil and gas companies compared to medium and small integrated oil and gas companies. I also compare the valuation of integrated oil and gas companies with independent exploration and production companies and both of those with oil service companies. I try to see if there's a valuation gap between European and US oil service companies, if there are opportunities in pure independent refineries, or in pipelines. I look for opportunities in the alternative energy space.

Next although I may like an industry, but when it comes to valuing stocks, I'm a value investor and if I can't find a stock at an ok valuation I will start again. I like to buy stocks that are cheap on several measures, including the price/earnings ratio.

Our investment universe consists of about 225 stocks and I screen it by four factors every week. We look at the return on capital over the last three years and define the companies in the top decile of our universe as good companies, the companies in the bottom decile as bad companies, and so on

We are mostly interested in the good companies that are also cheap. To find such companies we use a discounted cash flow model

We also rank stocks for changes in investor sentiment using analysts earnings changes and for signs of investor activity using price momentum..

Our objective is to identify good companies that are cheap and where both sentiment is improving and the price is showing a positive trend.

We weekly look at the five highest ranked stocks that we don't own and at the five lowest ranked stocks that we do own. And we look at the stocks that entered the top 25% of that universe.

Q: What are the key elements of portfolio construction?

A: The portfolio is built in a simple and clear way, with 28 stocks equally weighted at 3.5% of the portfolio. I equally weight them because I don't see why I should have five times as much in Exxon just because it's a much bigger company. If I like it and say Anadarko equally, they're going to have equal amounts. This gives me greater tracking error and ability to outperform against the index. Since my objective is to earn superior returns over the medium and long term for investors, I don't worry about short-term fluctuations against the benchmark.

Exceptionally I will divide a position up. For example, three years ago when I invested in Russia, I didn't have a strong conviction about which stock to own, so I put a third of a 3.5-percent unit into three stocks. Recently, when I wanted some exposure to US oil service companies, I liked companies with market cap of around \$1 billion, where liquidity was an issue so I put a third of a unit into each of those three. At the moment, subject to my small cap exposure which I discuss next that's the only exception to the equal size of holding rule..

On small-cap exposure. I used to allow myself three holdings in companies under \$1bn market capitalization. More recently this has evolved into an additional bit of portfolio philosophy. I've decided to allow myself to split one 3.5-percent unit of the portfolio into up to 8-10 holdings. The idea is to utilize smaller situations to give me access either to areas of the oil and gas industry that I didn't know enough about or where they can give me valuable insights or just very are cheap. But this is a rare exception to a pretty disciplined twenty-eight stock list that I have.

The main approach gives me an automatic sell discipline because, when I come across a stock that I want to buy, I have to think about what to sell. Also, whenever we get inflows or outflows, I tend to re-balance the fund so that the holdings go back to being equally weighted, taking into account the recent moves. I tend to be buying more of the

stocks that lagged and less of the stocks that have trended up strongly.

Q: Which benchmark do you use?

A: I have measured myself against the MSCI World Energy Index since I started managing offshore energy funds in 1999. The performance of the offshore funds can be found on the Morningstar offshore funds site although I cannot discuss it under SEC fund marketing guidelines.

The background to having a US mutual fund, which we launched on June 30, 2004, is that a little \$3 million offshore energy fund which I started running in 1998 had by then grown to \$138m. We decided its success merited

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TIM GUINNESS, Chairman and Chief Investment Officer has served as Guinness Atkinson's Chairman and Chief Investment Officer since the firm's founding in November 2002. From 1999 to November 2002, he was Joint Chairman of Guinness Flight Global Asset Management Limited and Chief Executive Officer from 1997 to 1999. While at Guinness Flight (which ultimately merged with Investec in 1998), Mr. Guinness was a founding portfolio manager of the Global Equity Fund, which was established in 1985. Mr. Guinness holds an Engineering Degree from Cambridge England and an MBA from the MIT, USA.

launching a clone of that fund in the US market. The original offshore fund has subsequently become two funds, and about \$1.9 billion. and the no load US mutual fund is now about a \$100 million. The US fund is therefore part of a \$2 billion pool as all my funds are run identically.

Q: What risks do you monitor and how do you mitigate them?

A: Essentially, the equal weight rule in my portfolio and the limit on small caps to a very small exposure, mean that there are in built risk controls. For example it means I'm not investing in new untried exploration companies that are very speculative. The construction of the portfolio itself takes care of the biggest risks.

I measure my tracking error, my volatility, the Sharpe ratio, but I don't particularly try to manage them. In my view, you can't outperform unless you have a tracking error of over 6% to 7%. Because of its construction, the fund has greater volatility against the index and there will be years when we'll underperform the index but this is a fund for the long-term investor and hopefully we'll outperform meaningfully in the long term.

The investors who consider our fund should first answer the question what they think is going to happen to the oil price. I think that a reasonable, cautious investor should say that \$57 for the next five or ten years is a reasonable bet and I would put a 50% probability on that. I would then put a maximum 10% to 20% probability on the oil price going down to \$40 or lower, and 30% to 40% probability on the oil price going up to \$100. This is a situation where you hope to make reasonable money in the most likely scenario, you've got a 30% to 40% chance of doing extremely well ie in the higher oil price scenario, and only a modest probability of losing some money ie in the worst scenario. But since nothing is risk free, nobody should put all their money into this fund or any single fund. **T**