ELECTRONIC INVESTOR

Survival Guides for Oil Investors

Online sources New Constructs and Valuentum prefer companies with strong balance sheets like Chevron. And what is Gran Tierra Energy?

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When oil prices slipped, the whole energy sector fell hard. Other commodity prices—and the stocks connected to them–have tumbled as well.

The group has “been overpriced for a while, as excess liquidity has chased too few assets,” explains David Trainer, founder and CEO of stock advisory New Constructs (newconstructs.com). “When commodity prices come back to earth, the stocks attached to them get blown up.”

It’s a classic blood-in-the-streets buying opportunity for anyone who can figure out which stocks can get back up again—and when. The models used by analysts at New Constructs and Valuentum Securities (valuentum.com) are well suited to that first task: identifying likely survivors. Figuring out when to buy them is much more complicated.

Both sites use discounted cash flow models and supporting calculations to separate strong stocks from falling knives. Both agree that, when the going gets tough, survivors will have two important qualities.

“THE HEALTH OF THE balance sheet and the cash-flow generating capacity of a company are key drivers,” says Brian Nelson, president of equity research at Valuentum. He founded the Chicago-based stock advisory in 2011 after helping develop the credit and equity models for Morningstar (morningstar.com).

“Free cash flow is the single most useful metric for investors,” adds Trainer. A forensic accountant, Trainer founded Nashville-based New Constructs in 2002. He always begins a stock analysis by translating the company’s accrual accounting values into numbers that reflect true shareholder value.

Free cash isn’t earnings, net profit, or other values commonly reported in corporate financials, explains Trainer. It’s the real surplus from operations that could be spent on dividends, buybacks, or capital investments that increase shareholder value. Valuentum calls it economic profit; New Constructs refers to it as economic value. In either case, the extent to which it’s above a stock’s market value quantifies the return potential.

It’s one of the calculations that both Websites employ to determine the relative

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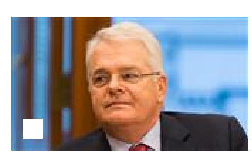

attractiveness of the issues they follow. Valuentum charges $150 a year for access to its proprietary metrics and portfolio recommendations. New Constructs' annual subscriptions start at $187 for similar services, including access to sortable tables of all the equities and funds it covers.

Always important, balance sheet quality (ability to service debt) and free cash become critical when sectors are under the kind of stress that commodities have been. Oil prices alone have tumbled more than 50% since summer, turning corporate leverage into an anchor, rather than an earnings multiplier.

Neither site finds much opportunity in the oil patch. The only energy companies that Nelson recommends are oil giant Chevron (ticker: CVX) and pipeline operator Kinder Morgan (KMI). Shale fracking leaders Continental Resources (CLR) and EOG Resources (EOG) would be attractive, he adds, if their performance weren't so closely tied to oil prices. "Oil is still taking damage," says Nelson, "and we have to wait for the dust to settle before we can get a read on market technicals."

New Constructs finds only 19 of 190 energy stocks attractive: Its top pick is Canadian oil producer Gran Tierra Energy (GTE), which has a solid balance sheet and extremely discounted market price. But trade timing is particularly tricky at present. And it isn't just energy stocks, says Trainer. New Constructs considers almost two-thirds of the 3,000 stocks it covers to be dangerous.

VALUENTUM USES A COMPLEX combination of technical indicators to help it decide when to add undervalued stocks to one of its portfolios.

New Constructs sends e-mail alerts to subscribers when an issue becomes either attractive or dangerous.

Trainer predicts a period of fundamental change for the market as stock values adjust downward.

"The market has been a voting machine, but it's returning to a weighing machine," he warns. "Any investor not focused on free cash flow now could get burned."

E-mail: mike@mikhogan.com

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