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Excerpts from Quarterly Report written by Investment Partners Asset Management – Q3 2014

"While we can (and do) invest in many industries, folks who have known us for a while are aware that we tend to favor the healthcare, technology, and natural-resources sectors (including energy). Specifically, we prefer value-oriented companies in these spaces because they tend to be businesses engaged in activities we can personally identify with, and are usually firms addressing common-sense economic demands…

This Quarter's Main Topic: Energy

Rather than dedicate this thought piece to the healthcare and technology market sectors mentioned above - it seems like it would be a good idea to spend some time speaking about the energy market which, as of late, has been extremely topical. Despite the recent rout in energy prices, we're not alone among value investors who believe that, over the long haul, energy investing remains viable. Warren Buffet and Carl Ichan, for example, both continue to hold significant stakes in North American oil and gas related companies – and at least at this point they don't seem to be changing their strategy. Let's examine why, currently, this sector remains an investible theme, in our opinion.

Anyone that has been following the oil market realizes that prices have declined roughly 25% - 30% for both Brent and West Texas Intermediate in the past 6 – 8 weeks. Pundits blame the pronounced drop on increasing supplies (from North American shale); decreasing demand (from Europe and Asia); and a strong US dollar relative to foreign currencies. While these reasons, to varying degrees, may indeed have an impact on oil prices, we do not believe they fully explain such a dramatic drop in such a short amount of time. It seems peculiar to us that the same energy demand which held Brent prices at nearly $115 / barrel of oil in June (and well north of $100 / barrel just a few weeks ago) has somehow dwindled so quickly that it justifies such a dramatic decline in prices. This is particularly odd when the world's largest consumer of energy, the United States (which consumes 20 million barrels of oil per day) clocks in with positive GDP growth and employment momentum. Notwithstanding the coincidence of this decline in energy prices with the phase-out of quantitative easing… we feel something *else* seems to be going on. To us, it may be just as simple as a good old fashioned price war on the part of OPEC's leader, Saudi Arabia.

"I'm turning Japanese, I think I'm turning Japanese – I really think so…." – The Vapors (1980)

You may wonder why anyone would want to spoil all the fun when oil producers all over the globe were making sizable profits at $110 / barrel only a few short weeks ago. For the rationale, we may want to look at history. Those of you who are old enough to remember may recall that back in 1980s Japan had a very lucrative business selling the United States $125 million worth of 64k semiconductors per year. (64k is just about enough RAM memory to power a financial calculator, by the way.) Around this time, Silicon Valley began ramping up the PC industry, and to meet the growing demand for microprocessors, a number of domestic chip manufacturers (some of which are now household-name tech companies) emerged. As you might expect, this did not please the Japanese semiconductor firms who wanted to preserve their share of the market. So they responded by *dumping* 64k chips on the US market at extremely cheap prices – prices so low that they were far below what it even cost for the Silicon Valley companies to manufacture the competing chips. Japan's strategy was to drive their US competitors out of business, reclaim their position as dominant players in the market, and then restore the previous price levels. As we all know, with the benefit of hindsight, the US market for semiconductors turned out to be much larger than the $125 million per year that the Japanese anticipated. In the end, the dumping tactics did not deter domestic manufacturers, and in the long term US semiconductor production wound up surging as worldwide demand proved large enough for many global players to thrive and prosper.

Game of Chicken

We believe that OPEC is playing a similar game that the Japanese did in the 1980s. Worried about their role as the world's largest and most profitable energy supplier, Saudi Arabia recently lowered the price of exports to North America, and yet simultaneously boosted prices to Asia. While they vehemently claim they are not engaging in a price war, OPEC's leader appears to be sending a message to US and Canadian energy producers who, through the shale and tar-sands booms of recent years, now threaten to become as significant on the world market as some OPEC members, albeit with a higher cost structure. (Saudi Arabia currently produces roughly 10 million barrels of oil per day with an average cost of production and transportation of approximately $30 / barrel. The US oil companies have recently been pumping as much as 9 million barrels of oil per day domestically with a total cost of production in the $60 to $70 range. Canadian firms produce roughly 4 million barrels of oil per day, with slightly lower costs than those of their US competitors.)

Political Realities

The slide in oil prices may be making for good theatrics in the short term as we've witnessed a rapid race for the bottom, but there are very real political consequences with a number of oil-producing countries. The fact of the matter is that certain sovereign nations rely on the revenue from more on expensive oil to balance their federal budgets, pay for social programs, and maintain their international currency reserves. In this regard Iran reportedly requires oil above $130 / barrel, while Venezuela and Nigeria each need oil above $110 / barrel. Russia desperately needs $100 oil, and even Kuwait and Saudi Arabia require $70 and $90 oil respectively. It may be for this reason that, as we write this, the US Energy Information Agency just released a report suggesting that oil is, indeed, heading for a new normal – and, in their opinion, that new normal is $80 to $90 / barrel in 2015. This is certainly lower level than previously experienced in 2014, but a far cry from the recent $70-handle prints on energy trading exchanges.

So – what's our point in all of this? We believe that all of this confusion in the energy markets could actually be creating an investing opportunity. The price of oil could certainly fall further, and stay low longer, for a host of reasons. But over the coming decades literally hundreds of millions of people in developing countries will experience a substantial improvement in their standard of living. That new economic activity will require a steady supply of energy, and while there will likely be a push to respond to this demand, at least in part, with renewable energy sources, we suspect that oil and natural gas will continue to play a significant role in powering vehicles, fueling energy plants, and providing heat. Regardless of where in the world those energy sources are produced, we believe the worldwide demand should ultimately result in much higher prices down the road – and potentially significant profits for energy firms.

So what are we looking for?

In our quest for securities in this space, we favor companies that have taken steps to hedge production and/or maintain balance sheet liquidity so that they can survive this commodity price level or even lower levels. We also prefer firms that can generate enough free cash flow to support reserve replacement, interest expense, production growth, and (in many cases) dividends or cash distributions. A myriad of such companies performed well through August. For a variety of reasons we currently believe the subsequent smackdown in the price of oil will prove to be temporary – with some energy analysts calling for a return to more normal levels by mid-2015. In the meantime, the low pricing environment has demoted what we consider to be *great companies* to the status of *firms operating admirably in the face of an adverse pricing environment*…

Other Sectors

We'll spend more time in future reports speaking about the other industries and sectors that we favor. Just to touch on a few items briefly, though, we have allocated capital toward a number of… healthcare stocks and technology stocks that we feel have promise. Additionally, our income-oriented securities (or bond surrogates as we sometimes call them) have continued to provide cash-flow in this continued low-yield environment. In a few instances, we have identified some opportunities where we have potential for both income and capital appreciation in the event discounts to net-asset value close.

A Final Note

We remain hopeful and enthusiastic about the future of our holdings…. In the meantime, we will continue to invest in companies and sectors that we perceive to be trading at discounts to their potential realizable values, and we thank you for your continued trust and support.

FORWARD LOOKING STATEMENTS

This discussion and analysis contains certain forward-looking statements and projections that involve a number of risks and uncertainties. Actual events or results may differ materially from the expectations and projections of the Managing Member. Past performance does not guarantee future results. Market and other risks may affect actual results achieved.