

Investor Newsletter



THINGS TO WATCH FOR:

OIL

Most majors had a hard time adding to reserves in 2004. With low production growth expectations for 2005-06, could the oil sector be ripe for M&A deals?

COMMODITIES

The CRB Index has broken out to multi-year highs. Our technical target of 334 was hit. We feel the index could see some consolidation at current levels.

CHINA

CNOOC's offer to buy Unocal was thwarted. They have offered 4.18 billion for Petrokazakhstan. The final price could be close to \$63 per share. China is expected to be placing additional demand on the oil market in the 4th quarter of 2005.

INTEREST RATES

Short term interest rates have risen substantially. The spread on the 2 year note to the 10 year is 22 bps. Investors are seeing no long-term inflation worries on the horizon.

Oil news is everywhere.

What to expect and where to invest

Since the last newsletter, our clients' holdings in the oil sector have risen fairly quickly. The price of crude oil hit our \$64 target faster than we anticipated. We were very happy to see this.

Everywhere one turns, there seems to be oil-related news popping up. Will Saudi Arabia cut, or won't they? My guess is that the spigot is wide open and that the pressure is on them to produce what is wanted. If they do cut, it is probably because of depletion.

In the last quarter Unocal was acquired by Chevron for over \$18 billion. This appears to be a fair price. Unocal had 2.2 billion in cash flow last year. Assuming a 5% growth rate, Chevron could see a 15% return on this purchase annually. This equated to about \$9.75 per barrel-of-oil equivalent ("BOE"). This is up over 20% from where other deals were done months ago. Of course, we view this as a positive for our clients.

We feel it important to discuss our views on the few oil stocks we hold in client accounts. Our view is that Occidental Petroleum and Amerada Hess are the cheapest oil companies out there.

Occidental has been firing on all cylinders. Re-entry into Libya and a gas project that is coming online in 2006 should boost their cash flow and add to reserve replacement. OXY recently announced that it shipped its first cargo of Libyan crude oil. Currently OXY estimates that this will lift production rates by 22,000 barrels per day.

Amerada Hess has been a show-me story. After making some acquisitions a

few years back, AHC is now benefitting from these. To appease Wall Street, AHC hedged their production, thus limiting their upside through 2005. Once into 2006 though, AHC will fully benefit from another \$30 per barrel on oil. We feel AHC could generate close to \$3 billion in cash flow by the end of 2006 if oil stays at current levels.

On the international front, the Japanese market appears to have registered a buy signal. Housing prices in Japan have started to advance, the banking sector seems to be dealing with the problems that it has faced for the last 15+ years, and corporations in Japan are talking about dividends. All of these issues speak the same thing: Attraction of Capital. Japan clearly seems to be on a path of re-inflating their economy. The latest news was that the economy grew at 3.3%, a surprise from the 1.5% prior growth. These are all positives for the Nikkei Index.

On the following page we have presented two charts. The first is of oil. One can clearly see that oil is breaking out of a 20+ year trend of sideways price. Frankly, oil is in a bull market. The second is of the Nikkei Index (Japan's stock index). After consolidating huge gains in the 80's, the Nikkei average was as oversold in 2003 as it was overbought in 1990. It appears to have broken a 15-year downtrend. This major reversal could signal a return to historic trends on the Nikkei, lifting it to a range of 16,000-18,000 on the index.

20+ YEAR CHART OF OIL

CRUDE IS BREAKING OUT

We would not be surprised to see oil consolidate its recent advances. Structural price targets are in place for \$80, \$90, and even over \$100 per barrel.



35-YEAR CHART OF THE JAPANESE MARKET

NIKKEI IS BREAKING OUT

A reversion to its 35-year trend would mean the Nikkei could trade to 16,000-18,000.



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Recent activity:

In the last quarter, we made several additions to our focus list. [Foundation Coal Holdings](#), and [Qwest](#) (both discussed below) replaced [Broadcom](#) and [Odyssey Re.](#) [Broadcom](#) reached our technical target rather quickly. As for [Odyssey Re.](#), we felt the company's financial numbers were not being realized by Wall Street.

Stocks we like:

[Foundation Coal Holdings \(FCL\)](#): \$36 Is the fifth largest coal company in the United States. A majority of its coal sales are to electric utility companies for the production of power. FCL has sales commitments in place for 85% of its 2006 production. FCL also has a reserve life of 28 years worth of coal in the ground. We believe that Foundation Coal could produce \$294 million in cash flow for 2005 and close to \$163 million in free cash flow.

[Qwest \(Q\)](#): \$4 Provides telecommunications service to 14 states in the Midwest and Mountain regions. Recently there has been much consolidation in this industry. Qwest is making progress in reducing its debt load. It appears that many companies, from Ebay to Google to Microsoft, are interested in the telecom infrastructure. This is evident in recent news releases and deals. Qwest recently announced that they will be working with Microsoft on offering small and medium

sized business customers with Voice over Internet protocol (VoIP). We feel Qwest could be the cheapest way for others to enter this sector. Consolidation is present in the industry, thus making Qwest an attractive asset given its severely discounted share price relative to peers.

[iShares for Japan \(EWJ\)](#): \$12 The Japanese market is up considerably from two months ago. Revitalization has seemed to hit the market. We feel that investors wishing to participate in the possible return to historic levels should be exposed to these iShares. Japan seems to be trading at a discount to its intrinsic value.

[BHP Billiton \(BHP\)](#): \$31 Reported very strong earnings for 2005. Cash flow beat our estimates by \$157 million to an impressive \$8.350 billion. BHP also raised its dividend for the year by 7.7%. Although some analysts on the street were disappointed in the dividend increase, we view this as sound management. The dividend increase backs our belief that BHP has historically grown at 8%. We view this as an indication of strong financial health and viability.

MARKET NUMBERS

Dow:	10,378
S&P:	1,196
Nasdaq:	2,106
Fed Funds:	3.75%
3-Month T-Bill:	3.90%
2-Yr. Note:	4.37%
10-Yr. Note:	4.59%
10-Yr. TIPS:	2.04%
U.S. GDP:	3.30%
CRB:	324.35
Oil:	\$60.76

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SELECTION LIST

INVESTING FOR GROWTH:

Stock/Symbol	Recommended	Recent Price	Gain/Loss	Target Price	Buy Limit
Archer Daniels/ADM	16.5	23.78	44.12%	47	22
BHP Billiton/BHP	11.99	31.05	158.97%	69	32
Comcast/CMCSK	30.80	27.32	-11.30%	43	33
ExxonMobil/XOM	38	56.77	49.39%	77	63
iShares for Japan/EWJ	9.80	11.85	20.92%	16	11.50
iShares for Netherlands/EWN	18	18.79	4.39%	22-24	18
Foundation Coal Hldgs./FCL	32	36.47	13.97%	73	36
Marathon Oil/MRO	32.50	60.89	87.35%	100	40
Occidental Petroleum/OXY	28	75.52	169.71%	100	85
Pogo Prod./PPP	39	50.42	29.28%	90	50
Qwest/Q	3.94	4.12	4.57%	9	4
Sempra Energy/SRE	25	42.83	71.32%	68	42
Service Master/SVM	13.04	12.59	-3.45%	17	13

INVESTING FOR INCOME:

Preferred Stock/Symbol	Recommended	Recent Price	Yield	Credit Quality
Amerada Hess/AHC pfd.	50	103.61	3.38%	BB+
HRPT Properties/HRP	9.99	10.85	7.74%	BBB
PIMCO Muni Income Fd II/PML	14.34	14.92	6.79%	A+
PIMCO Muni Income Fd III/PMX	13.95	14.82	6.73%	A+