

Indexing Consequences

Summary and Recommendation

Large energy stocks like buy-recommended **ExxonMobil (XOM)**, **ChevronTexaco (CVX)**, and **ConocoPhillips (COP)** may see increased weighting in the S&P indices beginning March 21 to reflect their widely held ownership. The index arbiter will weight stocks by capitalization that does not count shares of a control group, founding family, another company or a government. Another factor that tends to make buy-recommended energy stocks too cheap relatively is leverage. High-debt stocks like sell-recommended **Kinder Morgan (KMx)** are over-represented in the indices that weight by market cap rather than by total long-term assets. Index investors may be unaware of the distortions, but not investors who use the McDep Ratio that was invented in large part to neutralize the impact of leverage on valuation.

Widely-Held Stocks Underweighted in S&P 500

“Standard & Poor’s has announced details of the upcoming free float adjustments for the S&P 500, S&P MidCap 400, S&P SmallCap 600, S&P Composite 1500, S&P 100 and their related sub-indices. Beginning March 18, 2005 official S&P U.S. indices will shift to a half float-adjusted calculation. Each company will be adjusted by half of its intended float factor. On September 16, 2005 all official S&P U.S. indices will shift to a full float-adjusted calculation.” Source: Standard & Poor’s

Free float adjustments have been previously applied to overseas stocks, but apparently not to U.S. companies such as Wal-Mart, Microsoft and Oracle to name some large issues whose size has been overstated in indices. The long overdue change may have a greater market impact on the stocks negatively affected and more muted impact on all the rest.

In our research we have taken care not to overstate the investment importance of closely-held stocks. Investors may notice the percentages in parenthesis after buy-recommendations **Imperial Oil (30%)**, **PetroChina (10%)** and **CNOOC Ltd. (19%)**. The reference is to the proportion of shares widely held. Imperial is 70% owned by ExxonMobil. The Peoples Republic of China owns 90% of PetroChina and 81% of CNOOC. The shares, market cap and other size measures we summarize correspond only to the “free-float” shares when the float is less than 50% (see tables [Rank by McDep Ratio](#) and [Rank by EV/Ebitda](#)).

In the case of the KMx securities we make no adjustment for **Kinder Morgan, Inc. (KMI)**. For **Kinder Morgan Energy Partners (KMP)** and **Kinder Morgan Management (KMR)** we also show the entire shares outstanding for each security even

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though some are owned by KMI. We exclude present value and debt of KMP and KMR that is related to the general partner's incentive compensation equivalent to almost half of partnership equity. Most widely-used comparisons of stocks by value misrepresent the impact of the latter factor.

Low Debt Stocks Underweighted

Practically all of our buy-recommendations are low-debt stocks and therefore under-represented in the typical index fund. Our sell recommendations happen to be high-debt stocks and thus over-represented in index funds.

Index investors may have no choice, but to pay too much, albeit indirectly, for high debt stocks. It doesn't help that a keeper of the index gets paid by issuers for rating their debt. The more debt issues, the more fees S&P generates.

There is a better way. From time to time we make reference in our work to "unlevered weightings" in selecting a portfolio. The unlevered weighting means setting the size of positions according to market cap and debt, or total present value, rather than equity value. In a simple example one would own twice as much of a stock that had no debt compared to one that had 50% debt. If both stocks were in the same industry and had comparable fundamental prospects, the main difference in stock performance would likely be leverage.

For an indexing example, consider the comparison of buy-recommended **XTO Energy (XTO)** and sell-recommended KMI, both close to \$10 billion in market cap and likely to be weighted equally in a market cap weighted index like the S&P 500. XTO has a debt ratio of 0.16 compared to KMI's 0.74. If the stocks were weighted by total present value the index would have a weighting in XTO stock more than three times that in KMI $(1.00 - 0.16)/(1.00 - 0.74)$.

It is probably too much to expect that stock indices would reflect leverage as there may be too much at stake in hiding debt. KMI doesn't report the 0.74 ratio we calculate. Even though KMI has a financial interest in KMP of more than 50%, the federally sanctioned oligopoly of rating agencies, paid as they are by KMI and other issuers, apparently allow KMI to underreport the leverage in its financial pyramid.

Down playing or ignoring financial risk seems to be ingrained in our culture. Popular stock market commentary often trumpets high percentage equity gainers without regard to leverage. We do not hear in the popular commentary that the 50% debt stock underperformed because it went up only 18% while the no-debt stock went up 10%.

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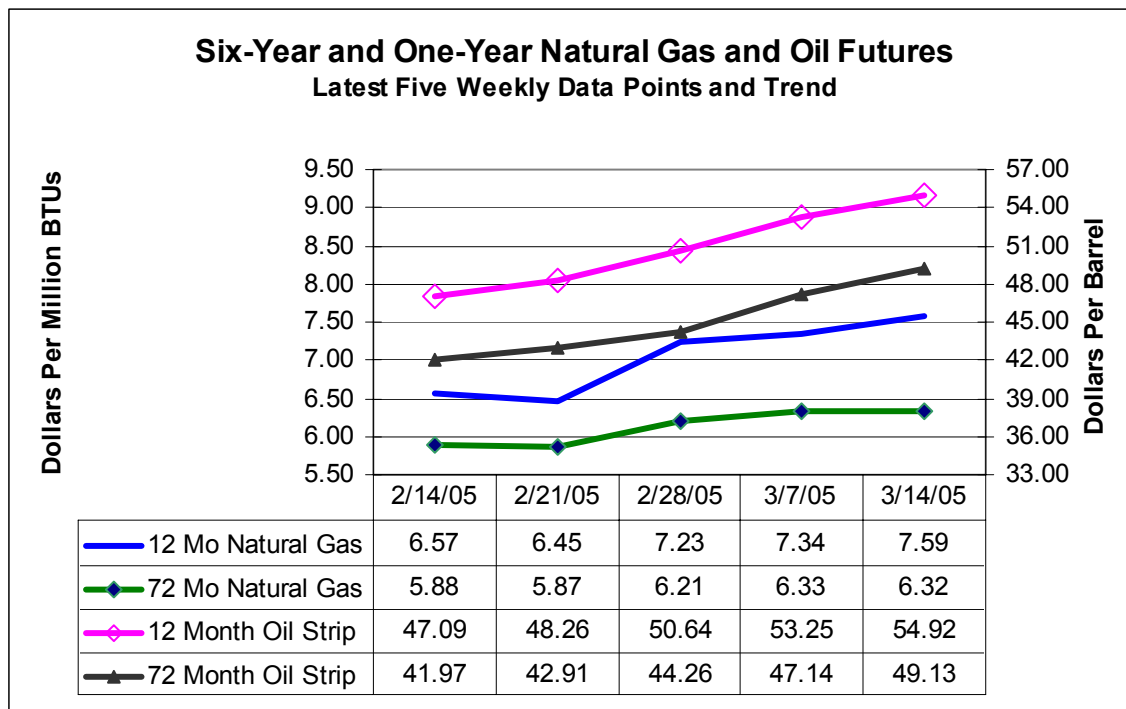
Stocks Lag Futures

Oil and gas producer stock prices were down last week while oil for delivery over the next six years set a new high in the futures market, now at \$49.13 a barrel (see charts [Latest Five Weekly Data Points and Trend](#) and [Six-Year Commodity Price Meter](#)). Oil for delivery over the next twelve months also set a new record at \$54.92 (see chart [Oil One-Year Futures](#)). One-year oil remains at less of a premium to its 40-week average than it was at the temporary peak last October.

McDep Ratios at a median of 0.92 suggest stocks are valued as though oil were less than \$37 (see table [Rank by McDep Ratio](#)). The median unlevered cash flow multiple is 5.1 times, median P/E is 10.1 and median dividend yield is 2.4% per year (see table [Rank by EV/Ebitda](#)).

Besides the weekly *Meter Reader* we update most of our single stock analyses at least once a quarter (see [Index of Recent Research](#)). Also we have a weekly analysis of *U.S. Natural Gas Royalty Trusts* with related single trust analyses.

Kurt H. Wulff, CFA

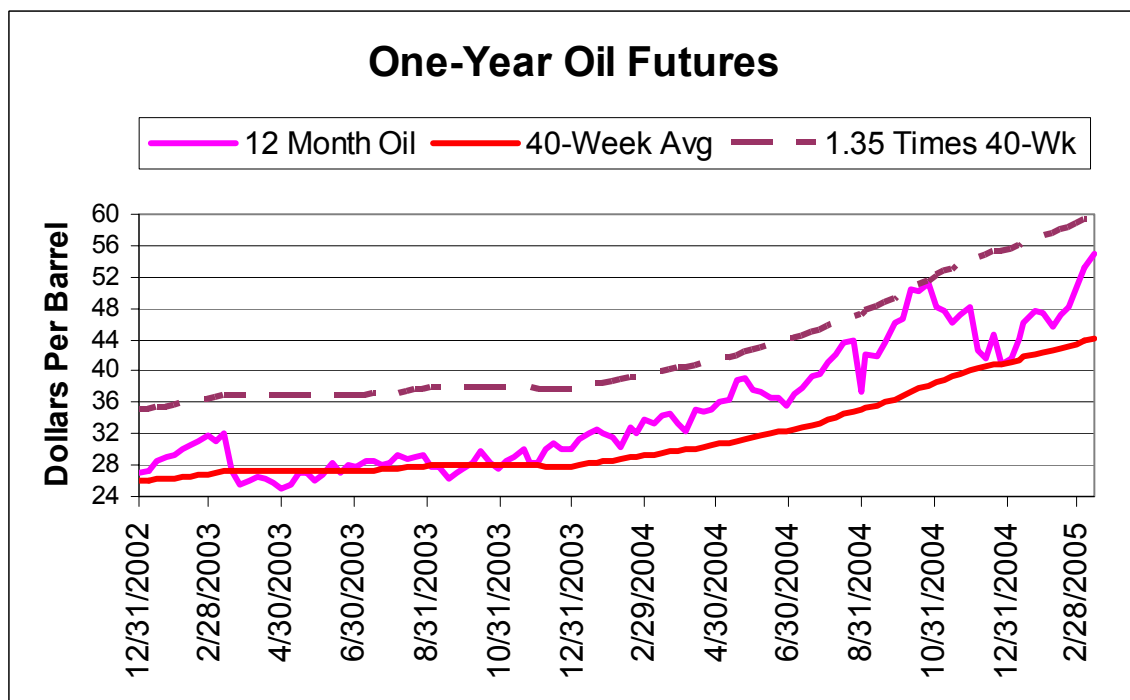
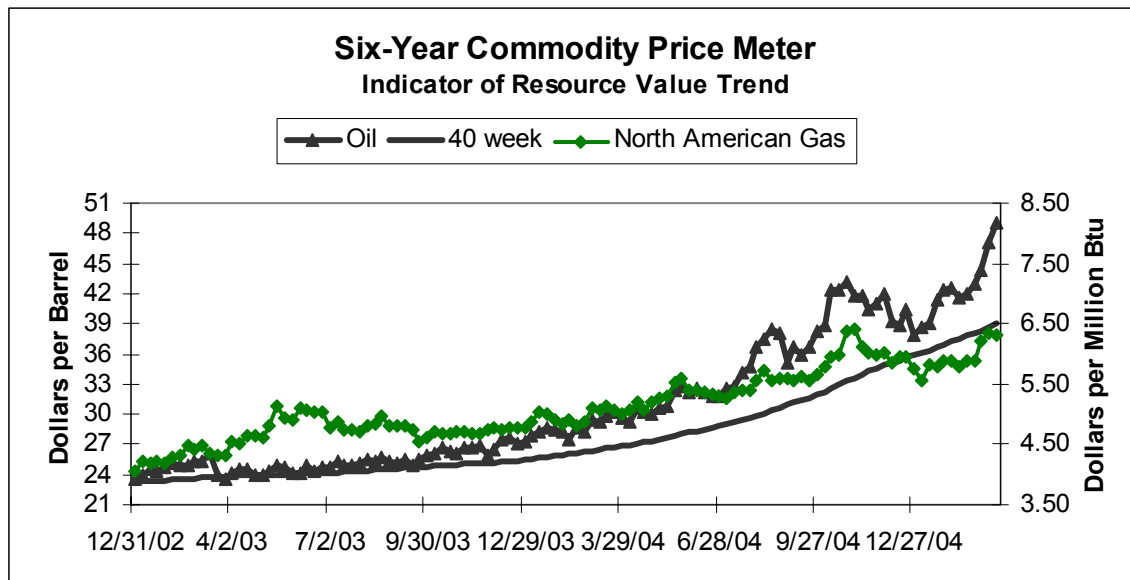


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Oil and Gas Producers Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating		Price (\$/sh) 14-Mar 2005	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Mega Cap								
Exxon Mobil Corporation	XOM	B	61.28	6,461	396,000	60.00	0.06	1.02
Shell Transport and Trading Co. plc	SC	B	56.97	1,587	90,000	55.90	0.16	1.02
BP plc	BP	B	64.65	3,601	233,000	64.00	0.12	1.01
Total S.A.	TOT	B	120.63	1,218	147,000	120.00	0.17	1.00
Royal Dutch Petroleum	RD	B	63.15	2,016	127,000	66.00	0.16	0.96
ChevronTexaco Corporation	CVX	B	58.94	2,123	125,000	76.00	0.10	0.80
<i>Total or Median</i>					<i>1,118,000</i>		<i>0.14</i>	<i>1.01</i>
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	79.28	125	9,910	20.00	0.74	1.78
Imperial Oil Limited (30%)	IMO	B	72.40	105	7,630	64.00	0.11	1.12
Marathon Oil Corporation	MRO	B	46.27	347	16,070	42.00	0.30	1.07
Norsk Hydro ASA	NHY	B	86.39	252	21,800	101.00	0.16	0.88
ConocoPhillips	COP	B	106.30	706	75,000	128.00	0.23	0.87
Petro-Canada	PCZ	B	58.70	264	15,500	70.00	0.18	0.87
Suncor Energy	SU	B	38.95	460	17,920	54.00	0.10	0.75
PetroChina Company Ltd (10%)	PTR	B	63.03	176	11,080	94.00	0.05	0.69
Lukoil Oil Company	LUKOY	B	135.75	209	28,000	208.00	0.03	0.66
<i>Total or Median</i>					<i>203,000</i>		<i>0.16</i>	<i>0.87</i>
Independent Natural Gas and Oil - Large Cap and Mid Cap								
XTO Energy Inc.	XTO	B	43.99	280	12,320	45.00	0.16	0.98
Unocal Corporation	UCL	B	62.33	271	16,900	65.00	0.21	0.97
Encana Corporation	ECA	B	69.32	471	32,600	77.00	0.16	0.92
Occidental Petroleum Corp.	OXY	B	72.40	406	29,400	87.00	0.15	0.86
CNOOC Limited (19%)	CEO	B	56.35	78	4,400	67.00	-	0.84
Devon Energy Corporation	DVN	B	47.54	500	23,800	63.00	0.16	0.79
Burlington Resources	BR	B	50.13	391	19,600	67.00	0.12	0.78
Anadarko Petroleum Corp.	APC	B	77.20	246	19,000	113.00	0.14	0.73
<i>Total or Median</i>					<i>158,000</i>		<i>0.15</i>	<i>0.85</i>
Independent Natural Gas and Oil - Small Cap								
Berry Petroleum Company	BRY	B	55.17	22	1,240	50.00	0.12	1.09
Energy Partners Ltd.	EPL	B	26.34	39	1,040	30.00	0.20	0.90
Cimarex Energy Company	XEC	B	39.84	81	3,210	50.00	0.15	0.83
Encore Acquisition Company	EAC	B	41.89	33	1,370	57.00	0.19	0.79
<i>Total or Median</i>					<i>6,900</i>		<i>0.17</i>	<i>0.87</i>
Income								
Kinder Morgan Energy Partners, L.P.	KMP	S3	46.52	150	6,980	15.00	0.52	2.02
Kinder Morgan Management, LLC	KMR	S3	43.27	56	2,440	15.00	0.52	1.91
Pengrowth Energy Trust	PGH		20.16	136	2,740	16.00	0.24	1.20
San Juan Basin Royalty Trust	SJT		34.65	47	1,620	30.00	-	1.16
Enerplus Resources Fund	ERF		37.25	104	3,870	32.00	0.17	1.14
Canadian Oil Sands Trust (US\$)	COSWF	B	64.80	91	5,910	94.00	0.16	0.74
<i>Total or Median</i>					<i>23,600</i>		<i>0.20</i>	<i>1.18</i>

B = Buy, S2 = Short half unlevered position, S3 = Short quarter unlevered position

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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Oil and Gas Producers

Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating		Price (\$/sh) 14-Mar 2005	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
Mega Cap								
Exxon Mobil Corporation	XOM	B	61.28	11.1	6.6	6.7	12	1.8
BP plc	BP	B	64.65	9.4	5.7	5.8	11	3.2
Total S.A.	TOT	B	120.63	8.9	5.6	5.6	11	2.7
Shell Transport and Trading Co. plc	SC	B	56.97	7.6	5.0	5.1	10	3.6
Royal Dutch Petroleum	RD	B	63.15	7.6	5.0	4.8	10	3.8
ChevronTexaco Corporation	CVX	B	58.94	9.7	6.0	4.8	8	2.7
	<i>Median</i>			9.2	5.7	5.4	11	2.9
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	79.28		7.5	13.3	18	3.5
Suncor Energy	SU	B	38.95	18.2	11.0	8.2	21	0.5
Imperial Oil Limited (30%)	IMO	B	72.40	10.6	6.5	7.2	13	1.0
Marathon Oil Corporation	MRO	B	46.27	7.9	5.3	5.6	11	2.4
Petro-Canada	PCZ	B	58.70	7.6	5.3	4.6	9	0.8
ConocoPhillips	COP	B	106.30	11.6	5.2	4.5	7	1.9
PetroChina Company Ltd (10%)	PTR	B	63.03	13.3	6.5	4.4	9	3.7
Norsk Hydro ASA	NHY	B	86.39	8.5	4.9	4.3	10	3.8
Lukoil Oil Company	LUKOY	B	135.75	12.2	3.7	2.5	4	2.6
	<i>Median</i>			11.1	5.3	4.6	10	2.4
Independent Natural Gas and Oil - Large Cap and Mid Cap								
XTO Energy Inc.	XTO	B	43.99	11.6	6.3	6.2	13	0.5
Occidental Petroleum Corp.	OXY	B	72.40	11.3	5.6	4.8	8	1.5
Unocal Corporation	UCL	B	62.33	8.5	4.9	4.8	10	1.3
Burlington Resources	BR	B	50.13	9.8	6.0	4.6	10	0.7
Encana Corporation	ECA	B	69.32	7.2	5.1	4.7	10	0.6
CNOOC Limited (19%)	CEO	B	56.35	9.6	5.2	4.4	8	3.2
Anadarko Petroleum Corp.	APC	B	77.20	11.9	5.8	4.2	8	0.9
Devon Energy Corporation	DVN	B	47.54	7.9	5.0	4.0	9	0.6
	<i>Median</i>			9.7	5.4	4.7	9	0.8
Independent Natural Gas and Oil - Small Cap								
Berry Petroleum Company	BRY	B	55.17	10.9	5.6	6.1	15	0.9
Encore Acquisition Company	EAC	B	41.89	15.6	6.7	5.3	11	-
Cimarex Energy Company	XEC	B	39.84	7.6	4.7	3.9	9	-
Energy Partners Ltd.	EPL	B	26.34	5.3	3.9	3.6	10	-
	<i>Median</i>			9.2	5.1	4.6	11	-
Income								
Kinder Morgan Energy Partners, L.P.	KMP	S3	46.52		7.6	15.3	20	6.3
Kinder Morgan Management, LLC	KMR	S3	43.27		7.6	14.5	18	6.7
San Juan Basin Royalty Trust	SJT		34.65	12.5	8.4	9.8	11	9.2
Canadian Oil Sands Trust (US\$)	COSWF	B	64.80	20.0	8.9	6.5	7	2.6
Enerplus Resources Fund	ERF		37.25	8.3	5.7	6.5	12	9.3
Pengrowth Energy Trust	PGH		20.16	7.9	5.0	6.0	9	11.3
	<i>Median</i>			10.4	7.6	8.1	12	8.0

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended March 31, 2006; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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Index of Recent Research

Stock Ideas

<u>Date</u>	<u>Symbol</u>	<u>Stock</u>	<u>Theme</u>
7-Mar	EPL	Energy Partners, Ltd.	Layer Cake
7-Mar	DVN	Devon Energy Corporation	Target Diversification
7-Mar	XEC	Cimarex Energy Company	Raise Net Present Value to \$50 a Share
7-Mar	XOM	Exxon Mobil Corporation	Raise Net Present Value to \$60 a Share
2-Mar	SU	Suncor Energy Inc.	Fire Tests Patience
28-Feb	CVX	ChevronTexaco Corporation	Raise Net Present Value to \$76 a Share
25-Feb	COP	ConocoPhillips	Raise Net Present Value to \$128 a Share
18-Feb	EAC	Encore Acquisition Company	Raise Net Present Value to \$57 a Share
17-Feb	APC	Anadarko Petroleum Corporation	Raise Net Present Value to \$113 a Share
17-Feb	XTO	XTO Energy Inc.	Raise Net Present Value to \$45 a Share
14-Feb	TOT	Total S.A.	Raise Net Present Value to \$120 a Share
10-Feb	* UCL	Unocal Corporation	Raise Net Present Value to \$65 a Share
9-Feb	* EPL	Energy Partners, Ltd.	South Timbalier Thrill
7-Feb	* BRY	Berry Petroleum Company	A Touch of Glamour
7-Feb	* DVN	Devon Energy Corporation	Raise Net Present Value to \$63 a Share
7-Feb	* IMO	Imperial Oil Limited	Raise Net Present Value to US\$64 a Share
3-Feb	* SJT	San Juan Basin Royalty Trust	Real Value with Income
1-Feb	* PCZ	Petro-Canada	Raise Net Present Value to US\$70 a Share
31-Jan	* COSWF	Canadian Oil Sands Trust	Raise Net Present Value to US\$94 a Share
31-Jan	* MRO	Marathon Oil Corporation	Raise Net Present Value to \$42 a Share
26-Jan	* XEC	Cimarex Energy Company	Magnum Hunter Acquisition Adds Value
26-Jan	* OXY	Occidental Petroleum Corporation	Raise Net Present Value to \$87 a Share
25-Jan	* ECA	EnCana Corporation	Raise Net Present Value to US\$77 a Share
19-Jan	* KMP	Kinder Morgan Energy Partners, L.P.	Energy Houdini
19-Jan	* KMI	Kinder Morgan Inc.	Energy Houdini
19-Jan	* KMR	Kinder Morgan Management, LLC	Energy Houdini
13-Jan	* NHY	Norsk Hydro ASA	Oil, Natural Gas and Aluminum
12-Jan	* LUKOY	Lukoil Oil Company	Profits Advance
7-Jan	* BR	Burlington Resources, Inc.	Royalty Trust Candidate
29-Dec	* LUKOY	Lukoil Oil Company	After Yukos
29-Dec	* CEO	CNOOC Ltd	Natural Gas Progress
27-Dec	* PTR	PetroChina Company Limited	West to East Pipeline Flowing
22-Dec	* RD	Royal Dutch Petroleum	Historic Streamlining
22-Dec	* SC	Shell Transport & Trading Company, p.l.c.	Historic Streamlining
20-Dec	* BP	BP p.l.c.	Cash Flows to Owners

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15-Mar		Index Consequences
8-Mar	*	Powerful Trends
1-Mar	*	Asset Reallocation
22-Feb	*	Wall of Worry
15-Feb	*	Just Buy
8-Feb	*	Happy Birthday to Meter Reader

* Archived on www.mcdep.com

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