THE WALL STREET JOURNAL.
WSJ.com

March 12, 2012

Drilling for Dollars

Investing in new energy-extraction techniques can be a challenge

ALTERNATIVE INVESTING | By Gregory Zuckerman

Q: Are there ETFs or other ways to play the boom in fracking and shale energy stocks?

A:There is growing excitement in the oil patch. Advances in drilling techniques such as horizontal drilling and hydraulic fracturing, or fracking, have made it easier to extract oil and natural gas from shale and other rock formations. Some early investors have scored billions in profits, and shares of pioneering companies, such as Continental Resources Inc., have surged about 40% in the past year.

But it's challenging for most individual investors to play this trend. Chesapeake Energy Corp. was among the first companies to bet on the new world of surging natural-gas production. But its shares are down more than 25% in the past year as gas prices have tumbled, underscoring the risks of specific companies involved in unconventional drilling.

Exchange-traded funds have offered few options as well. Scott Miller Jr., a managing partner of Blue Bell Private Wealth Management LLC in Blue Bell, Pa., notes that United States Natural Gas Fund has lost more than 80% of its value in the past two years, worse than natural-gas prices due to its reliance on futures contracts. Van Eck Market Vectors Oil Services, introduced in December, is up about 8% this year through Feb. 28, but it focuses largely on conventional oil and gas exploration.

Last month, however, Van Eck introduced a new ETF, Market Vectors Unconventional Oil and Gas—with the fitting symbol of FRAK. It invests in a range of companies that use fracking drilling techniques and those with exposure to shale oil, shale gas and related areas. One of its largest holdings, EOG Resources, has shifted the bulk of its production to oil from natural gas and is benefiting as oil prices soar.

A caveat for investors with larger portfolios: The fund is very small and sees well under 100,000 shares a day traded on some days, which means large trades could move prices, says Matthew Tuttle, president of Tuttle Wealth Management LLC in Stamford, Conn.

James Shelton, chief investment officer of Kanaly Trust in Houston, is steering clients to master limited partnerships like Kinder Morgan Energy Partners and Enterprise Products Partners . MLPs are companies that own and operate pipelines, primarily for natural gas and oil. They're partnerships and retain no earnings and pay no taxes; instead, they pay out all profits to partners, while their units trade on stock exchanges. These companies lately have been paying about 5% in annual distributions to unit holders, a figure that includes dividends as well as the return of capital and earnings.

"Because their revenues are primarily derived from transportation of energy products, they are less sensitive to commodity price changes than other energy-related equities," says Mr. Shelton.

Tad Borek, who runs Borek Financial, says it may be too late to make a big plunge into shale and fracking investments. He notes that these companies are seeing more scrutiny, due to the potential for environmental damage.

He recommends investing in certain energy-intensive industries that will benefit from low, long-term natural-gas prices, such as chemical companies.

Q: How do you evaluate the risks and rewards of Business Development Corporations? Morton Lurie, Raleigh, N.C.

A:Business development companies, or BDCs, invest in or lend to small or newer companies. There's growing interest in BDCs, partly because they can pay sizable dividends. BDCs also are finding more areas to invest and lend, given the ongoing weakness of many banks that can serve as competition, especially in the small-business market.

Some BDCs don't trade on an exchange and are available only to wealthy, accredited investors. But BDCs often are structured as closed-end funds, trade on a stock exchange and accept smaller investors as shareholders. As such, a BDC can allow an investor to bet on smaller companies—much like a venture-capital fund—but still enjoy the liquidity of an investment that actively trades.

Lorraine Monick, managing director of Harris myCFO Investment Advisory Services LLC, says the average publicly traded BDC has a yield of about 8.3%.

There are dangers to these investments, however. For one thing, many use borrowed money, or leverage, to generate returns, something in the past that proved dangerous to some BDCs.

Also, BDCs can invest in the debt of young, growing companies which can have a higher risk of failure and can be more economically sensitive, Ms. Monick notes. Many of the companies that BDCs invest in also don't have other access to capital, making them more dangerous.

"Because BDCs rely upon capital markets for continuous access to funds, they can take investors on a harrowing ride when the market swoons" and their access to capital dries up, says Darren Pollock, who helps run Cheviot Value Management LLC, an investment firm in Santa Monica, Calif. "Dividends get slashed when tough times prevail," which sometimes can send shares tumbling.

At the same time, "BDCs possess great flexibility in valuing the loans that they've made," Mr. Pollock notes. That has brought some BDCs controversy in the past as some have questioned how they value their holdings.

BDCs that don't trade publicly are even more dangerous, says Mr. Tuttle, who says brokers sometimes emphasize the high dividends paid by some BDCs, while glossing over their risks.

Stick with those with proven management teams, and read the fund's prospectus to make sure it can't use huge amounts of leverage, says Ms. Monick. Investors should make sure BDCs are just one part of a diversified portfolio, adds Ms. Monick, who says investors should "visit brokerage or research sites such as the Closed End Fund Association to obtain analyst reports on specific BDCs before investing."

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