GOLD & ENERGY ADVISOR

BONUS ISSUE

$19 February 2007 Bonus

"Who Is This Man, and How Does He Make His Clients So Much Money?"

"I'm so impressed with this man's unique approach to investing, I had to interview him for you. His clients have made an absolute killing in energy investments—while, at the same time, slashing their tax liabilities all the way down to *zero* in some cases. Read on to see how he does it!"

My special guest this month: Financial Planner John Towers

What's the best way to invest in energy?

Well, that depends. Here in *GEA*, I recommend investments that I think are the best ones available to everybody.

Obviously, this approach has worked handsomely. We're up 145 percent since inception in March of 2004.

By its nature, though, our approach is limited. In theory, somebody who gave you individually tailored advice should be able to beat a broader investment service like *GEA*.

In theory, a good financial planner should be able to construct a better plan for *your* exact situation than the more general plan that I'm limited to.

That's all just in theory, though. In reality, financial planners who can produce great returns for you are all too rare.

That's why I'm so excited when I actually manage to find one!

And this month, I want to introduce you to one of these rare finds: John Towers. John is not only helping his clients to make **spectacular** money in energy, he routinely saves them hundreds of thousands in taxes at the same time.

I'm a big fan of John's work. That's why I interviewed him recently, to create this Bonus Issue of *GEA* for you. I think you'll be as impressed as I am by what he's doing.

John was a Certified Financial Planner for 18 years, until he replaced that designation with the broader Qualified Financial Planner title that he still holds. He's also a Certified Senior Advisor, which shows that he not only knows numbers, he also knows people. He's also a Registered Representative with VSR Financial Services, Inc. (member NASD, SIPC, a Registered Investment Adviser).

But designations and qualifications don't tell you what he's actually done for his clients. For that, let's get to the interview!

Q: John, why don't we start by talking a little about your past history, to let our readers know what's possible with your approach?

I've been involved in the financial services industry since 1970. Obviously, during the 70s, stocks and bonds were two of the worst asset classes to be in.

So I learned the importance of diversification early on.

The approach I've developed over the years is designed to try to match long-term equity returns, but not necessarily by being only in stocks. I like stocks, by the way, just not all the time. They're not always the best place to be.

For many years, we've focused on alternative income programs, especially in energy and real estate. Our approach in energy is somewhat unique because our clients get direct access to private equity oil and gas programs. There are tremendous tax benefits, plus they're risk-managed too.

Q: Can you share some examples of what you've done for your clients?

One client joined me 5 years ago. Over the next few years, we helped him to zero his income taxes out, and we tripled his income over what he was doing previously. And he was a retired financial broker, with a net worth of several million, so he was already a sophisticated investor before he came to us.

Q: You tripled his income, and cut his taxes to zero?

Yes. I don't necessarily encourage people to zero out their taxes, but that's what he wanted to do. Personally, I cut my own tax bill by $200,000 last year using oil and gas programs. This kind of savings isn't unusual for my clients, depending on their personal situations. Tax reduction strategies are one of our strengths, but it has to fit with the client's risk tolerance.

Q: That's great. Any other examples?

I had another client whose company was bought out. He was facing a multi-million dollar tax bill. We cut it by half—$1.5 million down to $750,000 or so. At the same time, we diversified his portfolio into private equity programs, primarily into energy income opportunities.

We could have done even better for him if the company had been bought earlier in the year, instead of a December sale.

Q: So people need to think about tax planning early in the year?

Yes. By the end of the year, opportunities are more limited. We can still do a lot for people, but it's easier earlier in the year.

Q: I'm sure our readers want to know exactly how you do all this, but let's not talk about that quite yet. I also wanted to discuss how you diversify your clients' portfolios.

As I mentioned earlier, this is really important. Late in the year 2000, I received thank-yous from a lot of clients. They basically said, "Thanks for saving our bacon. Because we were diversified, we don't have to touch our stocks while they were down." They derived income outside of the usual equities, and so they could wait out the downturn.

THE GOLD AND ENERGY ADVISOR

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Q: I understand your business is booming because of all this.

Ever since the stock crash, people learned that stocks aren't the solution to all their problems. So we're not actively soliciting new clients. For several years now, all our business has come from referrals.

Q: And your business has grown during that time?

It's doubled.

Q: I'm not surprised. I know the services you offer are unusual. Let's talk about that for a minute.

Well, we're different than most other financial planners. I've been in the business for 37 years. And I'm totally independent—I work only for my clients, not for a brokerage firm. I do have a broker-dealer to do the paperwork for me—compliance and due diligence (I hate the paperwork)—but I'm completely independent, unlike a lot of other financial planners. So we shop the market to find better alternatives to help solve our client's problems.

Q: Let me interrupt for a minute. I think it's really important for our readers to understand how many of the brokers out there aren't necessarily working in their best interests. Can you talk about that for a moment?

Let's say you're taking advice from a broker who works for a Wall Street firm. He's stuck in a dilemma—he may have a fiduciary responsibility to you, but he's also an employee of the firm. That's a built-in conflict of interest.

Q: Why?

Wall Street's first priority is to capitalize corporate America. So it can never be too bearish for long; that would make people negative on the market. You might remember the research scandal about Wall Street firms touting dot-coms to their clients, while internal memos said the stocks were "dogs."

People have learned—or should have learned—that in most Wall Street firms, the investment banking side drives the brokerage side, despite their claims of a "firewall" between the two. Also, many Wall Street firms have, or used to have, in-house mutual funds. Well, guess what. The brokers got larger commissions for recommending their own firms' funds. Meanwhile many of the funds, for the most part, underperformed comparable funds managed by others.

I could give lots of examples of this. One prominent firm, whose name your readers would immediately recognize, started a fund in the late 90s. It was an Internet Fund. It shut down in 2003-2004 after losing 80% of its value, and the list goes on.

A financial advisor needs to look at your overall situation, a holistic approach. He needs to do what's best for you, not what's best for his brokerage firm. He needs to look at risks as well as returns.

Sometimes clients have a hard time understanding this. In 1999, the NASDAQ was up 85 percent, and some of our clients complained because we were up only a fraction of that. I warned them that anything that can go up 85% can also go down 85%, which is just about what it did. They thanked me later.

I told them that when you run with the herd, you get trampled.

Q: But as you said, you don't run with the herd. You approach this from a broader perspective.

Our job is to help clients make unemotional decisions about their money, by diversifying some of their funds out of the usual stocks, bonds, and cash. Right now we feel rare coins are in a bull market, and commodities are too. I believe that over the next 5-10 years, they'll outperform financial assets. A number of other respected advisors agree.

But we don't have a crystal ball, so we still diversify our clients' overall portfolios into various asset classes. Even though we're more bullish on energy, gold, silver, and platinum, we don't abandon stocks. We like to have inflation hedges like those, and deflation hedges like government bonds, as well.

Some people think diversification means owning large-cap, mid-cap, and small-cap stocks. In a secular bear market, they all can take a hit. So you need to look beyond having all your assets just in stocks / bonds.

Q: And you also include private equities in the mix. Let's talk about those.

These are things that most investors are not that aware of, which is a shame but that, too, is changing. We especially like private equities in energy and real estate.

Q: Let's talk about real estate first.

Many people are already familiar with REITs [Real Estate Investment Trusts]. But our approach is a little different. Instead of buying publicly traded REITs, we actually buy the real estate and have it managed for us. In today's market we are getting distributions of 5-10 percent annually, plus potential capital gains when we sell. Historically, directly-owned real estate is less-correlated to the stock market than REITs, although you do give up some liquidity. Of course, real estate values can go down also.

Q: But you don't manage the properties yourself?

No, we research the companies that are doing this, picking and choosing the ones with better track records that would be most appropriate for our clients.

Q: OK. Now let's talk about the part our readers are waiting for. How have you managed to slash your clients' taxes, while increasing their incomes?

First of all, I have to say that I'm not making projections or promises of returns of any kind. Our goal is to help our clients make above-average returns with below-average risks, and we've been successful in that for the most part, but past performance does not guarantee future results. The clients must be comfortable with assuming some risks and illiquidity in their portfolio.

Now that I've said that, I can tell you that, for qualified investors, I really like the energy programs we're involved in. I'm sure your readers have noticed that energy investments have done really well over the last few years.

Q: That's an understatement!

And our methods of investing in oil and gas are, I believe, far superior to many other methods.

Here's the basic idea. We use limited partnerships or other legal structures that allow the pass thru of tax benefits directly to investors. In turn, the partnerships drill and then own oil and gas properties, so the investors actually own the oil and gas reserves. And, unlike owning an individual well, the risks are fewer because they're distributed across 15-100 wells per program. If one or two wells are dry, it's not a big deal.

Q: Why is this good way to invest?

First of all, the tax benefits are very significant. The government allows you to deduct something called IDC, which stands for "intangible drilling cost." Depending on the legal structure of the partnership, you take some or all of this deduction *up-front*, the year you make the investment. In some cases, the tax benefits are spread over 4-5 years; however most of our clients opt to take the deductions up front. Across all our programs, the deductions average about 90 percent. So for every dollar invested, you get a deduction of 90 cents that first year.

If you're in the 35 percent tax bracket, that's a 31.5 percent return on your money (in tax savings) *immediately*. It even applies to AMT [alternative minimum tax]—you can shelter up to 40 percent. So if you had a $100,000 liability under AMT, you can shelter up to $40,000.

Q: That's outstanding. But the tax benefits don't stop there, right?

Right. Once these wells are on production, the partnership starts selling oil & gas. That means that as an owner, you get profits distributed to you while you own the wells. Most of these programs pay cash flow monthly, and the wells may produce for decades.

But the cash flow isn't taxed totally as ordinary income. Uncle Sam recognizes that an oil (or gas) well is a depleting asset. Each year, there are fewer barrels left in the ground. So you get a depletion allowance of 20-25 cents on each dollar of net income received over the life of the program. This shelters part of your distribution from taxes.

Q: And this distribution income can be substantial, right?

Yes. Some wells drilled in the 1970s are still producing oil and gas. The income distribution can last a long time, albeit on a declining basis, as does the depletion benefit.

And again, this is partially sheltered income. You get a dollar of spendable income, but, typically, only around 75 cents of it is taxable income.

Q: It sounds like this is a long-term investment, not just a quick speculation on energy prices.

Absolutely. Investors should be prepared to be in for the long haul.

Q: Are there any other benefits to these programs?

Yes. Some programs also give you deductions for depreciation of the drilling equipment over the first seven years you own them. Plus, because they're LLCs or partnerships, they're considered illiquid investments for estate tax purposes, which can reduce your estate taxes. It helps in gifting assets as well.

Q: So let me summarize just the tax benefits alone. You get an up-front IDC deduction, making an immediate 31.5 percent on your money (assuming a 35 percent bracket for a 90% write off). Then you also get monthly distribution checks, which will start within the first 12 months, but you only pay taxes on 75 cents of each dollar. The program can be used to reduce your estate taxes too. Finally, for some programs, you also get depreciation deductions. Is that a good summary?

Yes, that's how they work.

Q: That's remarkable. And you also said they're risk-managed. Let's talk about that.

We want to reduce the risks to our clients as much as possible. So we approach the oil and gas programs in two different ways.

Lower risks: Our Developmental Energy programs focus on developing areas known to have oil and gas reserves already. The companies are drilling in places like Appalachia and Texas—places which have produced lots of oil and gas. A successful development program typically will hit 85-95% of their wells. Our typical development program will have 25-100 wells.

Higher risk: We also offer "balanced" funds to do both developmental (lower risk) and exploratory (higher risk, hopefully higher return).

Technology has enhanced the chances of success on exploratory. For example, during the 20th century, there were over 55,000 holes drilled on the Continental Shelf in the Gulf of Mexico. Ninety-nine percent of them were shallower than 15,000 feet. Now with new 3D seismic imaging, we can "see" down to 30,000 feet or so. The government estimates there are trillions of feet of gas at these levels, although it's more expensive to get it out of course. In the Gulf of Mexico, two of every three exploratory holes are dry, but the third usually makes enough profit to carry the others.

Onshore, the better companies are hitting four out of ten. We cherry-pick among these companies, and try to choose the better performers for our clients.

Q: Which program is more popular: developmental, or exploratory?

Obviously, an exploratory program can be more profitable, since it's a brand-new find. A big strike can be a windfall, but you also might get nothing at all. Most of our clients stick with the developmental side. They're not interested in home runs, just singles and doubles.

Q: I imagine these programs overall are a big hit with your clients.

Owning the wells gives you a nice hedge against rising energy costs. You pump gas into your car, and you say "ouch." Then you go home and find a nice check in your mailbox. Suddenly it's not so much of an "ouch" after all.

Q: Why aren't other financial advisors offering these kinds of programs?

Only a handful of broker-dealers have access to good oil and gas companies—mostly just the ones that maintained good relations during the hard times of the 80s and 90s. One of our co-founders used to be an oil & gas analyst, so we have a comfort level for energy. In past programs, we've partnered with some major companies: Chevron, Shell, BP, Apache, Devon, Newfield, Noble, and a long list of others. (Although I'm obligated to say that "these may or may not be our partners in future programs," etc.)

Also, these programs are smaller, niche market opportunities, too small for Wall Street to get involved with.

Q: So what kind of returns can you get with these kinds of programs?

I'm not going to make income projections. But in the last few years, some of these programs have paid out 100 percent in only three to four years. After that, the returns continue, although they decrease because underlying assets are depleting. The results of a program will vary considerably depending on the future prices of oil and gas. Past performance is no guarantee of future results.

Overall, these are good long-term income streams with great tax advantages, but definitely much riskier than CDs.

Q: You already talked about reducing the risk by buying 15-100 wells for each program. But this still assumes oil and gas prices don't plummet.

Right. We think the biggest risk, particularly for our developmental programs, is a significant fall in the future prices of oil and gas.

Q: Which in my opinion, has a very low chance of happening.

I tend to be in the Matt Simmons camp that says we're at or near peak oil. This would mean that we'll have plenty of oil for years to come, but the days of cheap oil are gone. I believe energy will stay expensive, and go higher from here over time. Obviously, a major world slowdown would impact prices negatively in the short run.

Q: I've gone on record predicting $100 oil in the medium-term, and not only because of peak oil.

I agree. I'm not necessarily setting specific price targets, but I definitely agree on the direction.

Q: Plus commodities overall are in a bull market.

When you add in the massive amount of new consumers in emerging economies—China, India, South East Asia—that will be competing with us in the commodity market, well, they weren't even around during the last bull market. The planet is getting smaller and commodities are getting dearer.

Q: And few analysts have even noticed, which is typical for the early stages of a bull.

I also believe we need to hedge against a decline in the dollar, which I think is coming long-term. I'm actually bullish on the dollar short-term, but long-term I think it's in trouble.

Q: I think so too, but tell me why anyway.

You can make a graph of the dollar vs. gold since Nixon closed the gold window in the early 70s. The dollar makes a downward descending line, and gold makes an upwards ascending line. My question to clients is this: where would you want your long-term investment dollars to be?

There's definitely a very strong monetary inflation bias built into our system. I don't see that changing.

Q: Yes. That's both structural and a result of policy as well.

John mentioned Matthew Simmons and peak oil. In case you were wondering what he was talking about, here's the background.

Matthew Simmons is a Houston energy investment banker with some 37 years of experience. He's become known for ignoring rosy industry predictions, and letting the data speak instead.

Unfortunately, what the data are saying turns out to be pretty scary. Simmons believes that global oil production is about to start a gradual, but permanent, decline. We won't run out of oil any time soon, but prices are going to be forced inexorably upwards as a result of declining supply. (Especially since demand from rapidly-industrializing countries like China continues to swell.)

The Middle East contains most of the world's remaining oil. Other regions are still producing new discoveries, but for decades now these have all been insignificant. With a global consumption of 84 million barrels per day, anything short of a huge strike hardly makes a dent in our supply/demand curve. And the Middle East is the only place with any potential for large strikes.

Unfortunately, most of the Middle East's production has peaked. Kuwait, Iraq, Iran, Oman, Yemen, Syria, Jordan… all these nations have either passed their peak production and are declining, or else they didn't have huge amounts of oil in the first place.

That leaves Saudi Arabia—the only oil country with the potential to significantly increase production. The world's future oil supply rises and falls on Saudi Arabia.

Simmons recognized all this years ago, and wanted to know just how reliable the Saudi oil was. Unfortunately, as he soon found out, there's little data to be had on Saudi oil. Ever since the Saudis nationalized (i.e., confiscated) their oil infrastructure from the Western companies that built it, they've allowed very little information to leak out about their reserves. Their obsessive secrecy has become legendary.

Fortunately for us, Simmons didn't let this deter him. He started an obsession of his own—digging into geological field reports to reverse-engineer the data and construct an accurate picture of Saudi reserves. He eventually went through about 250 detailed reports from the archives of the SPE (Society of Petroleum Engineers).

His results are disturbing, to say the least. If Simmons is even half right about the true condition of the Saudi reserves, we're in serious trouble.

The Saudis produce about 11 million barrels per day, and claim to have another 10 million barrels of extra capacity on top of that. But Simmons has found little proof of any extra capacity. Worse, he found lots of evidence that the largest Saudi fields are probably peaking right now.

Setting aside the "peaking now" issue for the

Yes. So much is structural now.

Structurally I think we've just about sunk our ship as far as being the shining star in the world. I think the rest of the world is going to catch up or pass us as they turn to free markets. We have taken on too much debt.

I don't see how anyone can be comfortable with having all their eggs in one basket in the US. Foreigners control our debt and indirectly our interest rates now. The Chinese have billions of dollars and at some point they could decide to dump them. It's just a question of when it's no longer convenient for them to own the dollars, and they feel like they're strong enough to sever the tie. I think it's very unwise to put our economic security offshore.

Q: Me too, but it's too late now. All we can do now is wait. John, I'm sure by this point some of our readers will want to know more about your services. I understand most of your programs are for SEC-accredited investors. For readers who aren't familiar with the term, what does that mean?

An SEC-accredited investor either has a net worth in excess of $1 million, OR has a high income. For single earner households, "high income" is defined as an adjusted gross income of $200,000 for the last two years, and projected again for this year. In a two-earner household, high income means $300,000. That's a strange way to do it, but those are the SEC definitions.

We have some non-accredited programs available, but most of our better performers are typically for accredited investors only. By the way, regulators are threatening to raise the net worth requirements. So be forewarned.

Q: Who is a good client for you?

First, someone who wants to manage their own stock and bond portfolios, but would like non-correlated private equity opportunities to help diversify their portfolio.

moment, let's discuss the lack of spare capacity. Global oil demand increases every single year—lately the increases have been a couple of million barrels or so each year. By 2025, according to U.S. government numbers, global demand will be 120 million barrels daily, and the Saudis will have to supply 22 million barrels of that.

Is this even possible? When a TV reporter asked Simmons about this, here was his reply:

"I would say that the probability of me living on the moon is higher odds than Saudi Arabia producing 22 million barrels a day."

As Simmons points out, even if the Saudis actually have the oil, they don't have the physical infrastructure to produce it:

"The Saudis are out of capacity...They have no infrastructure or extra pipes or gas, oil, and water separators (very expensive large globes used to separate what comes out of a water injection well). They have very heavy oil which, through a conventional refinery, produces asphalt. We don't need asphalt. We need gasoline."

So why don't they just build more infrastructure? Simple—oil infrastructure is expensive, and will be completely useless once the oil itself is gone. Building more infrastructure now would risk the oil giving out before the construction costs were recovered, if the decline starts soon.

Which leads us to Simmons' second finding. He's now questioning the size of Saudi reserves. He's been quoted in the *New York Times* and elsewhere.

After reviewing all those technical papers on Saudi oil, Simmons now doubts the published reserve figures. The Saudi government vehemently denies his analysis, and even claimed recently that their reserve estimate of 262 billion barrels is far too low. (They claim to expect another 150 billion barrels.) But the Saudis have provided no evidence for this hard-to-believe claim; it would require some spectacular new finds, and there's been no evidence for this. As author and professor Richard Heinberg has said, "Unless such evidence soon emerges, it would probably be safe to characterize the Saudi statements as an act of desperation intended to shore up U.S. support for the increasingly embattled monarchy."

Simmons backs up his analysis with some grim figures. 90 percent of Saudi oil comes from just seven key fields. On average, these fields have been in production for almost 50 years.

By far the most important field in Saudi Arabia—and the entire world—is the gigantic Ghawar field. It produces almost five million barrels per day, about five times as much as the next biggest Saudi field (Safaniya). This one field alone has produced about 55 percent of all Saudi oil since it came online in 1951. But Ghawar has been worked hard for over 50 years, and now requires an intense waterflood program (where water is injected into the well to force the oil out).

Second, someone who's a delegator—he or she wants to enjoy retirement, or has a $1-$2 million rollover that scares them, and wants to delegate to someone they can trust to look out for their best interests. They can monitor their investments, but not worry over daily market ups and downs. I try to ensure all my clients are diversified properly—that means they're in income programs totally non-correlated to stocks and bonds. Energy income programs are just one aspect of that.

Q: I believe you offer people a free consultation to see if your programs are a good fit?

Yes. I'm available at 1-800-999-6669, or at 1-972-377-8088.

Q: One last question. We talked about rising energy prices, declining dollar values, and bull markets in commodities, especially gold. How much of this sort of macro-analysis do you do as part of your work?

First and foremost, we're financial planners. So we can't ignore the macro, but we can't ignore the micro either. Certain investments are shorter term; other investments are longer-term plays to take advantage of structural deficiencies in our system like inflation.

Plus, on top of inflation, there's the potential for peak oil. I believe that energy prices will soon go up on their own, independent of the dollar, much like gold decoupled from the dollar.

We think eventually the whole commodity complex could look that way. There's 2.1 billion new potential consumers coming on board and wanting to get a piece of the "American dream" and our standard of living.

I'm not a gloom-and-doomer, but I'm not ignorant of the problems either. I notice what's going on. I follow Ben Franklin's approach: pray for the best and prepare for the worst. That's why they have lifeboats on cruise ships!

A decline of Ghawar seems to be coming sooner rather than later. This would not only be disastrous for world markets, but the field's 87 billion barrels of reserves will also be called into question. (It doesn't matter how much oil is left in the ground if you can't get it out.)

Other Saudi fields aren't much better. The highest-producing field after Safaniya is Abqaiq, which is the kingdom's oldest field, and is 73 percent depleted. Its key producing areas are now leftover pockets of bypassed oil.

The Saudis recently increased production from their Qatif and Abu Sa'fah fields, by 800,000 barrels per day. This sounds like a lot, but was barely enough to offset the decline of maturing fields. Plus, Qatif is high in hydrogen sulfide—making for very "sour" oil, useless to many refineries. Qatif has been a very difficult field to work: Saudi engineers recently said 45 percent of potential drilling sites into the field "were rejected due to safety concerns."

Another 41 billion barrels of Saudi reserves are in Khurais and Manifa. But some analysts question if any of this oil is obtainable at all. For example, Khurais has been a problem field for some 40 years—over 90 wells have tried to get oil to flow properly, and all have failed. Neither field is operating right now—some say they never will. If so, scratch 41 billion barrels from the world's reserves.

So overall, the world's reserves are probably a lot smaller than we think. And I haven't even discussed the flat-out lying that many OPEC nations have indulged in, claiming that their reserves are larger than they truly are. We "lost" almost five percent of the world's oil a year or so ago, when Kuwait was caught lying and corrected its claimed reserves. Other OPEC nations are obviously inflating their reserves even worse than Kuwait did, but haven't been forced to 'fess up—not yet, anyway.

Incidentally, I wrote extensively about Simmons' study in my book, *Global War for Oil*. (The section about Simmons that you just read, starting with his quote about living on the moon, was adapted from what I wrote about him there.) If you haven't heard much about peak oil before, or OPEC lying and inflating their reserves, or the other coming problems with our oil supply, I recommend you read my book. It reveals a lot of information that the media would rather you didn't know about.

So what's the bottom line of all this, as we end this Bonus Issue? Simple—I think John Tower's investment approach is right on the money.

John believes that the primary risk in his approach is a decline in oil and gas prices. Obviously, I think there's little chance of that happening, not only because of Matthew Simmons but also because of everything else I wrote about in my book. As John mentioned, he's in agreement with me—not only on the direction of oil's price, but on gold as well. They're going up from here!