Income and Dollar Diversification
The U.S. Natural Gas and Oil Royalty Trust Account

Summary and Recommendation

U.S. natural gas and oil royalty trusts pay high current distributions and offer portfolio diversification of the risk in the real value of dollar-denominated investments. We reinstate our research coverage of six stocks and combine it with our continuing coverage of **San Juan Basin Royalty Trust (SJT)** to constitute a new group of seven. Despite our lack of a current Buy recommendation of a U.S. royalty trust, we find that far-sighted investors often continue to own issues we have recommended at different times for the past twenty five years. We begin the reinvigorated coverage by setting up a real account with roughly equal holdings of seven stocks whose future returns we expect to measure and try to anticipate (see table U.S. Natural Gas and Oil Royalty Trusts – The Account).

U.S. Natural Gas and Oil Royalty Trusts
The Account

	Symbol/	*Price ($/sh) 30-Sep 2004*	*Shares*	*Market Value ($)*
Cross Timbers Royalty Trust	CRT	33.18	400	13,272
Dorchester Minerals, L.P.	DMLP	20.27	700	14,189
Hugoton RoyaltyTrust (46%)	HGT	28.05	500	14,025
Mesa RoyaltyTrust	MTR	59.98	200	11,996
Permian Basin RT (41%)	PBT	11.52	1,200	13,824
Sabine Royalty Trust	SBR	40.10	400	16,040
San Juan Basin Royalty Trust	SJT	30.51	500	15,255
Total				*98,601*

Slaking the Thirst for Income

Estimates in preparation are expected to show distribution yields for the Next Twelve Months ended September 30, 2005 (NTM) in the range of high single digits, about 8% for the equal-weighted account. Most of that may be a real rate of return after inflation that we expect can be supported by discounted cash flow analysis.

Swelling ranks of investors depending on income in retirement want more income than offered by the safest alternative, Treasury Inflation Protected Securities. Individuals seek higher income from direct investments or from funds that add diversification and management. The thirst is so strong that investors often pay too much for income as they "reach for yield". The challenge then becomes finding income that is not only higher, but backed by sound asset value.

Royalty trusts in our coverage represent ownership or royalty interests in generally high-quality, long-life natural gas and oil properties. That implies low operating risk. Having no debt, the trusts have no financial risk. The trusts do have commodity risk that we would redefine as a valuable characteristic in these times.

Diversify Dollar Risk

The most conservative investment, U.S. Treasury Bills, is exposed to the erosion of value of the currency. Not only is there the continuous debilitation of inflation that is probably higher than reflected in the Consumer Price Index and other official measures, but also vulnerability to a surprise devaluation of the dollar. For the past century the dollar held its value among the best of currencies. The past may not foretell the future. There is some probability of surprise events that would happen so fast there is no time to adjust after the fact. For example, some officials in our government would have China revalue its currency upward. That would be an overnight price increase in all the manufactured goods we import from China and an effective revaluation of the dollar downward. Other officials from time to time apparently contemplate a deliberate attempt to devalue the dollar more directly. We are not monetary experts, but rather believers in the motto "Be Prepared".

Fortunately, royalty trusts are likely to be quite effective in diversifying dollar risk because they represent practically pure representation in real assets whose value would readjust in the event of dollar devaluation. Natural gas is priced relative to oil which is priced globally, not locally. Because energy is necessary for not only for growth, but also for everyday living, it will always be in demand and the price will be whatever is required.

We are already seeing how the income of royalty trusts adjusts to changing oil and gas price. When SJT was paying a dollar per year its price was $8 to $10 a unit, a distribution yield of 8-10% a year. Meanwhile inflation has continued and natural gas price has adjusted upward. Now SJT is likely to pay $2.50 per year and its price has increased to more than $30 a unit, a distribution yield of more than 8% a year.

Royalty Trusts Valued Approximately at Long-Term Commodity Price

Because royalty trusts have outperformed operating companies the past few years, we have shifted our "buy" emphasis toward the latter. Moreover, practically speaking, the market capitalization of royalty trusts is small compared to that for mega, large and mid cap companies. Companies seem to be valued as though the long-term price of oil was less than $30 a barrel, while six-year futures, the average of the next 72 months, are currently priced above $35 a barrel.

Royalty trusts appear to be valued near six-year futures. We will address that point more specifically as we proceed with detailed analysis. Our moderate price scenario suggests that six-year futures are still low.

We should also emphasize that the higher value of royalty trusts relative to other stocks can be explained in several ways. In the most direct terms, a distinct advantage of the trusts is that the owners control reinvestment.

One specific difference is compensation. Companies may divert 5%, 10% or in the case of a leading pipeline income stock, more than 40% of value to compensate management. Because royalty trusts are defined assets, there is no cost of management beyond modest fees to conscientious trustees.

Another advantage of U.S. royalty trusts is the absence of hedging. Because the trusts have no debt there is no need to hedge to provide necessary insurance or to meet arbitrary standards of lenders. Because the trusts have no management there is no need to hedge because of any false rationalization. The trusts pass through commodity price to owners with no loss of value to financial derivatives. Trust investors can add their own hedge or financial leverage as they wish. In fact the use of the trusts as a hedge against dollar devaluation would not work as well if the trust were to hedge, too.

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