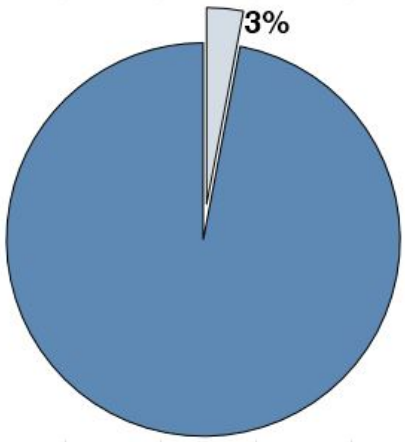
Investing in Energy

Energy Sector Report

Recommended Equity Weight for Energy: 3%



Buy-rated companies mentioned in this report:

Oil, Gas and Fuels Subsector:

Integrated Oil & Gas:
- **Chevron (**CVX - $155.48)
- **Suncor** (SU - $36.86)
- **TotalEnergies SE ADR** (TTE - $53.88)

Storage and Transport:
- **Enbridge** (ENB - $40.97)
- **TC Energy** (TRP - $51.35)

Refining and Marketing:
- **Marathon Petroleum** (MPC - $91.98)
- **Valero** (VLO - $118.74)

Prices and opinion ratings as of market close on 6/16/2022; subject to change. Source: Reuters.

For more information:

Individuals can obtain the full research report with full disclosures on any of the companies mentioned in this report by contacting a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131. Information about research distribution is available through the Investment Services link on www.edwardjones.com.

Sector Investment Summary

We believe the near-term outlook for the energy sector remains volatile. Growing geopolitical risks driven by the invasion of Ukraine by Russia and ongoing supply disruptions in the oil markets have driven near-term oil prices and the energy sector higher. As tensions cool and supply disruptions subside, we see a risk that commodity prices could slip alongside energy-sector valuations. Given elevated commodity prices, we remain focused on owning stocks in the integrated oil, storage & transportation, and refining & marketing subsectors over the long term, where companies have strong financial positions that allow them to weather commodity-price volatility and support dividends. As a result of relatively weak operating fundamentals and high volatility, we do not favor the exploration & production or energy equipment & services subsectors.

Key Investment Points

Oil price volatility expected in the near term - Oil prices are likely to vary widely over the next several months. Although the invasion of Ukraine by Russia continues to be a key contributor to unsettled global oil prices, we believe this volatility is also the result of the market attempting to balance recovering demand with potential production increases from suppliers like OPEC members, the United States and Iran.

Addressing climate change is a headwind for long-term demand - A strong (post-pandemic) recovery in oil demand has been seen with the help of vaccines, but the long-term outlook is uncertain given the global transition to low-carbon fuels.

Poor performance hurts investor interest - Although the energy sector has outperformed the broader U.S. market over the past year, the sector has generally delivered poor stock performance over the preceding decade, given low profitability and volatile oil and natural gas prices. Longer-term, we think investor interest in the sector will likely be influenced by better returns and performance once there is more confidence in the sustainability of the current oil-price cycle.

Dividends supported by those with strong balance sheets - The average dividend yield of the energy sector is more than double the market yield. We see the integrated oil & gas, storage & transport and refining & marketing subsectors offering a compelling combination of high dividend yields and competitive dividend growth.

Risks - Primary risks of investing in the energy sector include volatile commodity prices; changes in demand; and political, environmental, currency, regulatory, and legal risks.

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Please see important disclosures and analyst certification on page 5 of the report.

Investment Summary

We continue to expect wide swings in oil prices over the next several months as the market finds the right balance of supply and demand. We remain focused on recommending stocks in the integrated oil, storage & transportation, and refining & marketing subsectors. We believe the companies with strong financial positions and cash flow will be best equipped to weather commodity-price volatility and support their dividends.

Key Challenges

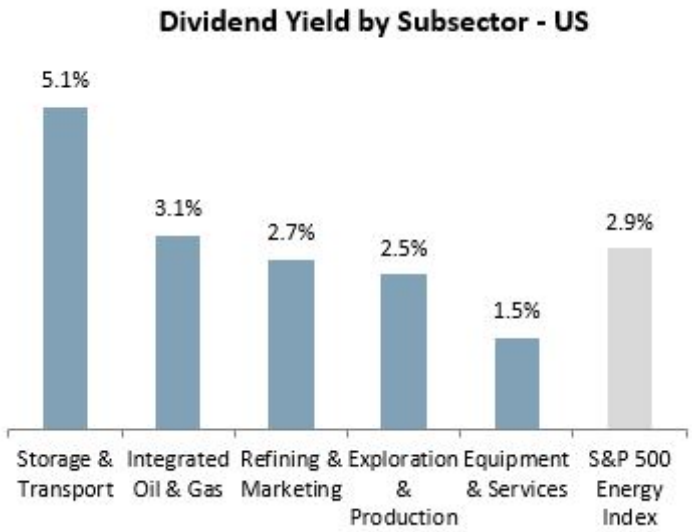
Near-term price volatility expected for oil. We see the near-term outlook for oil prices as volatile given the high level of uncertainty associated with the invasion of Ukraine by Russia, the quantity and duration of OPEC curtailments, and the impact of growing initiatives targeted at addressing climate change and lowering carbon emissions. Over the longer term we expect oil prices to range between $50 to $70 per barrel and natural gas prices to range between $2.00-$3.50 per thousand cubic feet.

Uncertain long term oil demand outlook. In 2020, global oil demand weakened significantly due to the negative economic impacts of the COVID-19 pandemic. Despite the marked recovery of demand for oil with the help of vaccines, the long-term outlook is still uncertain. In the long run, the pace of oil-demand growth is uncertain due to the global economy's shift to low-carbon fuels. We expect a slight increase in oil and natural gas demand for the next decade, with oil potentially plateauing after that as the global economy transitions away from fossil fuels.

Poor historical performance hurts investor interest. The energy sector has delivered poor stock performance over the past decade given low profitability and weak oil and natural gas prices. As a result, the energy sector's overall share of the S&P has declined from over 14% in 2008 to approximately 5% today (Source: Bloomberg, 6/9/22). We think investor interest in the energy sector remains low because of its poor track record, relatively high volatility, and skepticism toward companies' ability to consistently generate positive free cash flow.

Key Positives

Compelling dividend yields. Only those companies with strong financial positions will be able to support their dividends during periods of severe commodity-price weakness like we witnessed during the COVID-19 pandemic. During that time there were numerous dividend cuts across the exploration & production and energy equipment & services subsectors. The average dividend yield of the energy sector is now more than double the average market yield. However, the yield varies significantly by subsector. The storage & transport subsector offers the highest dividend yields, and these dividends are well-supported by stable, fee-based cash flows. The integrated oil & gas subsector offers a compelling combination of high dividend yields, low but consistent dividend growth, and a return to share repurchases. In addition to offering solid dividend growth, the refining & marketing subsector offers high yields. The exploration & production subsector's yield remains below the average of the energy sector. Traditionally, these companies have used cash flow to reinvest in growth, but the strategy has shifted from growth to a focus on increased cash return to shareholders.



Source: FactSet. Data as of 6/9/2022. The S&P 500 Energy Index is composed of 24 companies included in the S&P 500 that are classified as members of the energy sector. The energy subsector indexes are subsets of the S&P 500 Energy Index. Past performance is no guarantee of future results.

Valuation below average. The energy sector is trading below its historical average, but the discount varies by subsector. Compared with 10-year historical average price-to-cash-flow ratios, the exploration & production subsector is trading about 12% below average. The energy equipment & services subsector is currently trading at a 13% premium to its historical average. We do not favor either of these subsectors because of their relatively weak operating fundamentals and high volatility. Compared with 10-year historical averages, the integrated oil & gas subsector is trading at a 14%

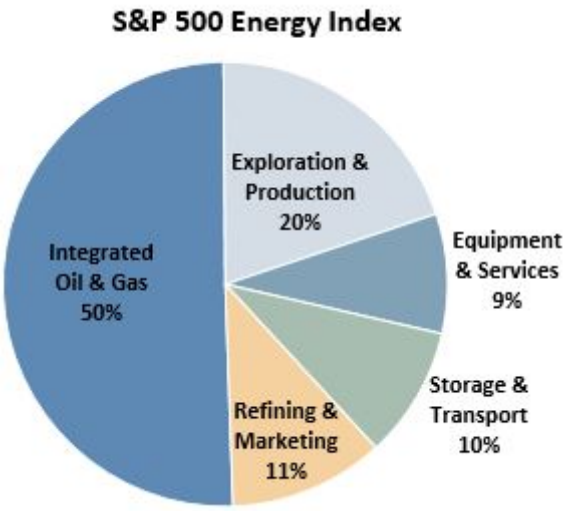
discount and storage & transportation at a 22% discount, while refining & marketing is trading at a 16% premium. We see valuations in these three subsectors as more compelling given their strong financial positions and focus on returning cash return to shareholders over the long term.

Environmental, Social and Governance (ESG) Considerations

ESG risks in the energy sector primarily consist of climate change and environmental impacts, such as carbon emission, biodiversity, land use and waste management. Business ethics such as policies and practices related to bribery and corruption, particularly in emerging markets, can also create risks. Other risks include workplace safety, community relations and community inclusion. Most of the companies we recommend are taking the essential steps to address these concerns by reducing emissions and investing in cleaner forms of energy, while maintaining solid safety track records.

How to Invest in the Energy Sector

We recommend that energy stocks comprise 3% of an investor's equity portfolio. There are key differences between energy subsectors, and we encourage clients to establish a base of holdings with the larger, more diversified integrated oil & gas companies. Due to their diversified operations, integrated oil & gas companies tend to have less volatile earnings and share prices while offering attractive dividend yields well above the market average. Integrated oil & gas stocks also tend to hold up better when oil prices are falling. However, they also tend to not rise as much as other energy stocks when oil prices are rising. Stocks from the other subsectors can serve to complement integrated oil & gas stocks in a portfolio because they tend to offer more growth and perform better in a rising oil-price environment. Energy stocks can be very volatile given the commodity-sensitive nature of cash flows.



Source: FactSet. Data as of 6/9/2022. The S&P 500 Energy Index is composed of 24 companies included in the S&P 500 that are classified as members of the energy sector.

We prefer companies with a strong financial position, positive free cash flow, a competitive dividend yield, and a solid track record of dividend growth. We prefer energy stocks in the integrated oil & gas, storage & transportation, and refining & marketing subsectors that exhibit these characteristics. We think the exploration & production and the energy equipment & services subsectors will continue to underperform. **See the list on page 1 for all of our Buy-recommended energy stocks.**

We view the current valuations of the energy stocks listed on page 1 as attractive. Methods used to evaluate the attractiveness of energy stocks include price-to-cash flow (P/CF); enterprise value (market capitalization plus debt) to earnings before interest, taxes, depreciation and amortization (EV/EBITDA); and discounted cash flow analysis. Most of the energy sector is highly capital intensive, and these significant capital expenditures result in high levels of noncash depreciation charges that depress earnings. As a result, traditional valuation measures like price to earnings (P/E), price to book value (P/B), and P/E to growth and dividend yield (PEGY) are not applicable for most stocks in the energy sector.

Subsector Descriptions

Integrated Oil & Gas:
Integrated oil & gas companies offer size, scale, strong financial positions, and geographically diverse operations. These companies typically operate in

all segments of the energy value chain, with a large focus on the upstream and downstream segments, which provides diversification benefits, as upstream benefits from rising oil prices while the downstream tends to be hurt and vice versa. Integrated oil & gas stocks tend to pay higher dividends, offer less growth over time, and tend to be less volatile in the longer term. Investors tend to own them for the dividend and stability when the industry is out of favor. Integrated oil & gas stocks we recommend with a Buy rating are **Chevron, Suncor and TotalEnergies**.

Storage & Transport:
The storage & transportation subsector, commonly referred to as "midstream," encompasses the piece of the energy value chain that comes after the exploration and production of oil and natural gas. It consists of the gathering, processing, transportation and storage of oil and natural gas. With minimal direct commodity-price exposure, companies in this subsector have relatively stable and predictable cash flows, allowing them to pay out a large percentage of their cash flow as dividends. Though most contracts have little direct exposure to commodity prices, price changes can indirectly impact short-term stock performance by changing oil and gas throughput volume expectations and counter-party risks. The midstream stocks we recommend with a Buy rating are **Enbridge and TC Energy**.

Refining & Marketing:
Refining & Marketing (R&M) companies purchase oil, turn it into finished products such as gasoline, diesel, heating oil and jet fuel, and then sell them to consumers. Refiners have significant commodity-price exposure because they purchase oil and sell products that can see prices move separately from oil. Relatively low capital-spending requirements result in significant free cash flow generation, which is being returned to shareholders via dividend increases and share repurchases. R&M stocks we recommend with a Buy rating are **Marathon Petroleum and Valero**.

Exploration & Production:
Exploration & production (E&P) companies explore, drill wells and produce oil and natural gas. These stocks tend to outperform when commodity prices rise and underperform when commodity prices fall because they do not have other operations to provide diversification benefits. We do not have any Buy-rated stocks in this subsector.

Energy Equipment & Services:
The energy equipment & services subsector provides drilling and production equipment and other needed services in the upstream segment. Given poor operating fundamentals and high volatility, the subsector's profitability has historically been unattractive. We do not cover any stocks in this subsector.

Sector Relative Performance

Source: FactSet as of 6/9/2022. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results. The S&P 500 Index is based on the average performance of 500 widely held common stocks. The S&P 500 sector indexes are subsets of the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee future results.

The S&P 500 Energy Index has underperformed the broader market over the last three years due primarily to low profitability and weak oil and natural gas prices.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Faisal Hersi, CFA; Nick Hummel, CFA

Required Research Disclosures

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