

PETROLEUM & RESOURCES CORP
Form N-30B-2
October 19, 2006

PETROLEUM & RESOURCES CORPORATION

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Chairman, President and Chief Executive Officer
Executive Vice President
Vice President, General Counsel and Secretary
Vice President, Chief Financial Officer and Treasurer
Vice President
Vice President Research
Assistant Treasurer
Assistant Secretary

Stock Data

Market Price (9/30/06)	\$ 32.68
Net Asset Value (9/30/06)	\$ 37.12
Discount:	12.0%

New York Stock Exchange ticker symbol: PEO

NASDAQ Mutual Fund Quotation Symbol: XPEOX

Newspaper stock listings are generally under the abbreviation: PetRs

Distributions in 2006

From Investment Income	\$ 0.29
From Net Realized Gains	0.10
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Total	\$ 0.39
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2006 Dividend Payment Dates

March 1, 2006

June 1, 2006

September 1, 2006

December 27, 2006*

*Anticipated

LETTER TO STOCKHOLDERS

We submit herewith the financial statements of the Corporation for the nine months ended September 30, 2006. In addition, there is a schedule of investments, along with other financial information.

Net assets of the Corporation at September 30, 2006 were \$37.12 per share on 21,113,090 shares outstanding, compared with \$35.24 per share at December 31, 2005 on 21,621,072 shares outstanding. On March 1, 2006, a distribution of \$0.13 per share was paid, consisting of \$0.07 from 2005 long-term capital gain, \$0.03 from 2005 short-term capital gain and \$0.03 from 2005 investment income, all taxable in 2006. A 2006 investment income dividend of \$0.13 per share was paid on June 1, 2006, and September 1, 2006.

Net investment income for the nine months ended September 30, 2006 amounted to \$7,913,401, compared with \$6,057,328 for the same period in 2005. These earnings are equal to \$0.37 and \$0.28 per share.

Net capital gain realized on investments for the nine months ended September 30, 2006 amounted to \$60,893,034, the equivalent of \$2.88 per share.

The total return on net asset value (with dividends and capital gains reinvested) of shares of the Corporation was 6.6% for the nine months ended September 30, 2006. The total return on the market value of the Corporation's shares in the period was 2.2%. These compare to a 9.2% total return for the Dow Jones Oil and Gas Index and an 8.5% total return for the Standard & Poor's 500 Composite Stock Index over the same time period.

For the twelve months ended September 30, 2006, the Corporation's total return on net asset value was 2.9% and on market value was (1.5)% as the discount widened during the period. Comparable figures for the Dow Jones Oil & Gas Index and the S&P 500 were 1.5% and 10.8%, respectively over the twelve month time period.

By now, you should have received the proxy statement concerning the upcoming Special Meeting of Stockholders on November 7, 2006. As is more fully described in the proxy statement, we are calling the Special Meeting to obtain your approval of a comprehensive rewriting and updating of our corporate charter. We believe that the charter amendments will provide your Board of Directors with additional tools needed to strengthen its ability to further the interests of the Corporation and our long-term shareholders. Your vote is very important and we urge you to vote in favor of each of the eight charter amendment proposals. If you have not yet voted, please call the Altman Group at 1-800-314-9816, extension 7309, and they can assist you in voting your proxy.

Current and potential shareholders can find information about the Corporation, including the daily net asset value (NAV) per share, the market price, and the discount/premium to the NAV, at our website (www.peteres.com). Also available at the website are a brief history of the Corporation, historical financial information, and other useful content. Further information regarding shareholder services is located on page 15 of this report.

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By order of the Board of Directors,

Douglas G. Ober,

Chairman, President and

Chief Executive Officer

October 13, 2006

STATEMENT OF ASSETS AND LIABILITIES

September 30, 2006

(unaudited)

Assets

Investments* at value:

Common stocks and convertible securities (cost \$324,572,197)	\$ 732,139,569	
Short-term investments (cost \$49,993,188)	49,993,188	
Securities lending collateral (cost \$31,187,345)	31,187,345	\$ 813,320,102
Cash		297,148
Receivables:		
Investment securities sold		2,647,431
Dividends and interest		695,624
Prepaid pension cost		710,382
Prepaid expenses and other assets		470,339
Total Assets		818,141,026

Liabilities

Investment securities purchased	578,013	
Open written option contracts at value (proceeds \$594,291)	671,900	
Obligations to return securities lending collateral	31,187,345	
Accrued expenses	2,065,596	
Total Liabilities	34,502,854	

Net Assets	\$ 783,638,172
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Net Assets

Common Stock at par value \$1.00 per share, authorized 50,000,000 shares; issued and outstanding 21,113,090 shares (includes 16,109 restricted shares, 4,800 restricted stock units, and 868 deferred stock units) (Note 6)	\$ 21,113,090
Additional capital surplus	292,372,441
Undistributed net investment income	1,853,481
Undistributed net realized gain on investments	60,809,397
Unrealized appreciation on investments	407,489,763
Net Assets Applicable to Common Stock	\$ 783,638,172
Net Asset Value Per Share of Common Stock	\$37.12

* See Schedule of Investments on pages 9 and 10.

The accompanying notes are an integral part of the financial statements.

STATEMENT OF OPERATIONS

*Nine Months Ended September 30, 2006**(unaudited)*

Investment Income	
Income:	
Dividends	\$ 9,920,539
Interest and other income	1,016,819
<i>Total income</i>	10,937,358
Expenses:	
Investment research	1,221,189
Administration and operations	762,942
Directors' fees	296,787
Reports and stockholder communications	190,596
Transfer agent, registrar and custodian expenses	119,480
Auditing and accounting services	70,908
Legal services	47,421
Occupancy and other office expenses	177,665
Travel, telephone and postage	57,033
Other	79,936
<i>Total expenses</i>	3,023,957
Net Investment Income	7,913,401
Realized Gain and Change in Unrealized Appreciation on Investments	
Net realized gain on security transactions	60,893,034
Change in unrealized appreciation on investments	(21,321,582)
Net Gain on Investments	39,571,452
Change in Net Assets Resulting from Operations	\$ 47,484,853

The accompanying notes are an integral part of the financial statements.

STATEMENTS OF CHANGES IN NET ASSETS

	Nine Months Ended September 30, 2006	Year Ended December 31, 2005
	(unaudited)	
From Operations:		
Net investment income	\$ 7,913,401	\$ 11,391,783
Net realized gain on investments	60,893,034	26,239,852
Change in unrealized appreciation on investments	(21,321,582)	153,388,454
<i>Change in net assets resulting from operations</i>	47,484,853	191,020,089
Distributions to Stockholders from:		
Net investment income	(6,166,552)	(12,030,248)
Net realized gain from investment transactions	(2,158,550)	(25,924,473)
<i>Decrease in net assets from distributions</i>	(8,325,102)	(37,954,721)
From Capital Share Transactions:		
Value of shares issued in payment of distributions	5,722	14,748,314
Cost of shares purchased (Note 4)	(17,694,628)	(24,891,727)
Deferred compensation (Notes 4,6)	253,675	104,296
<i>Change in net assets from capital share transactions</i>	(17,435,231)	(10,039,117)
Total Increase in Net Assets	21,724,520	143,026,251
Net Assets:		
Beginning of period	761,913,652	618,887,401
End of period (including undistributed net investment income of \$1,853,481 and \$106,632, respectively)	\$ 783,638,172	\$ 761,913,652

The accompanying notes are an integral part of the financial statements.

This report, including the financial statements herein, is transmitted to the stockholders of Petroleum & Resources Corporation for their information. It is not a prospectus, circular or representation intended for use in the purchase or sale of shares of the Corporation or of any securities mentioned in the report. The rates of return will vary and the principal value of an investment will fluctuate. Shares, if sold, may be worth more or less than their original cost. Past performance is not indicative of future investment results.

NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

1. SIGNIFICANT ACCOUNTING POLICIES

Petroleum & Resources Corporation (the Corporation) is registered under the Investment Act of 1940 as a non-diversified investment company. The Corporation is an internally-managed fund emphasizing petroleum and other natural resource investments. The investment objectives of the Corporation are preservation of capital, the attainment of reasonable income from investments, and an opportunity for capital appreciation.

Security Valuation Investments in securities traded on national security exchanges are valued at the last reported sale price on the day of valuation. Over-the-counter and listed securities for which a sale price is not available are valued at the last quoted bid price. Short-term investments (excluding purchased options) are valued at amortized cost. Purchased and written options are valued at the last quoted asked price.

Security Transactions and Investment Income Investment transactions are accounted for on the trade date. Gain or loss on sales of securities and options is determined on the basis of identified cost. Dividend income and distributions to shareholders are recognized on the ex-dividend date, and interest income is recognized on the accrual basis.

2. FEDERAL INCOME TAXES

The Corporation's policy is to distribute all of its taxable income to its shareholders in compliance with the requirements of the Internal Revenue Code applicable to regulated investment companies. Therefore, no federal income tax provision is required. For federal income tax purposes, the identified cost of securities at September 30, 2006 was \$405,722,907 and net unrealized appreciation aggregated \$407,597,195, of which the related gross unrealized appreciation and depreciation were \$414,269,677 and \$6,672,482, respectively.

Distributions are determined in accordance with income tax regulations which may differ from generally accepted accounting principles. Accordingly, annual reclassifications are made within the Corporation's capital accounts to reflect income and gains available for distribution under income tax regulations.

3. INVESTMENT TRANSACTIONS

The Corporation's investment decisions are made by a committee of management, and recommendations to that committee are made by the research staff.

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Purchases and sales of portfolio securities, other than options and short-term investments, during the nine months ended September 30, 2006 were \$69,004,175 and \$103,628,551, respectively. Options may be written (sold) or purchased by the Corporation. The Corporation, as writer of an option, bears the risks of possible illiquidity of the option markets and from movements in security values. The risk associated with purchasing an option is limited to the premium originally paid. A schedule of outstanding option contracts as of September 30, 2006 can be found on page 12.

Transactions in written covered call and collateralized put options during the nine months ended September 30, 2006 were as follows:

	Covered Calls		Collateralized Puts	
	Contracts	Premiums	Contracts	Premiums
Options outstanding, December 31, 2005	1,940	\$ 292,777	1,050	\$ 129,891
Options written	5,949	913,039	6,220	743,346
Options terminated in closing purchase transactions	(650)	(90,747)	(990)	(121,079)
Options expired	(4,811)	(531,520)	(3,980)	(459,990)
Options exercised	(1,198)	(183,929)	(750)	(97,497)
Options outstanding, September 30, 2006	1,230	\$ 399,620	1,550	\$ 194,671

4. CAPITAL STOCK

The Corporation has 5,000,000 authorized and unissued preferred shares without par value.

On December 27, 2005, the Corporation issued 438,416 shares of its Common Stock at a price of \$33.64 per share (the average market price on December 12, 2005) to stockholders of record on November 22, 2005 who elected to take stock in payment of the year-end distribution from 2005 capital gain and investment income.

During 2006, the Corporation issued 164 shares of its Common Stock at a weighted average price of \$33.67 per share as dividend equivalents to holders of deferred stock units and restricted stock units under the 2005 Equity Incentive Compensation Plan.

The Corporation may purchase shares of its Common Stock from time to time at such prices and amounts as the Board of Directors may deem advisable.

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

Transactions in Common Stock for 2006 and 2005 were as follows:

	Shares		Amount	
	Nine months ended September 30, 2006	Year ended December 31, 2005	Nine months ended September 30, 2006	Year ended December 31, 2005
Shares issued in payment of dividends	164	438,416	\$ 5,722	\$ 14,748,314
Shares purchased (at a weighted average discount from net asset value of 9.7% and 8.1%, respectively)	(525,550)	(806,050)	(17,694,628)	(24,891,727)
Net share activity under the 2005 Equity Incentive Compensation Plan	17,404	9,030	253,675	104,296
Net change	(507,982)	(358,604)	\$ (17,435,231)	\$ (10,039,117)

5. RETIREMENT PLANS

The Corporation's qualified defined benefit pension plan covers all employees with at least one year of service. In addition, the Corporation has a nonqualified defined benefit plan which provides eligible employees with retirement benefits to supplement the qualified plan. Benefits are based on length of service and compensation during the last five years of employment. The Corporation's policy is to contribute annually to the plans those amounts that can be deducted for federal income tax purposes, plus additional amounts as the Corporation deems appropriate in order to provide assets sufficient to meet benefits to be paid to plan participants. During the nine months ended September 30, 2006, the Corporation contributed \$23,406 to the plans and expects to contribute an additional \$400,000 to the plans during the remainder of 2006.

The following table aggregates the components of the plans' net periodic pension cost for the nine months ended September 30, 2006.

Service Cost	\$ 251,157
Interest Cost	245,993
Expected return on plan assets	(234,143)
Amortization of prior service cost	28,288
Amortization of net loss	169,022
Net periodic pension cost	\$ 460,317

The Corporation also sponsors a defined contribution plan that covers substantially all employees. For the nine months ended September 30, 2006, the Corporation expensed contributions of \$72,290. The Corporation does not provide postretirement medical benefits.

6. EQUITY-BASED COMPENSATION

The Stock Option Plan adopted in 1985 (1985 Plan), which has been discontinued for new grants, permitted the issuance of stock options and stock appreciation rights for the purchase of up to 895,522 shares of the Corporation's Common Stock at the fair market value on the date of grant. The exercise price of the options and related stock appreciation rights is reduced by the per share amount of capital gains paid by the Corporation during subsequent years. Options are exercisable beginning not less than one year after the date of grant and stock appreciation rights are exercisable beginning not less than two years after the date of grant. The stock appreciation rights allow the holders to surrender their rights to exercise their options and receive cash or shares in an amount equal to the difference between the option exercise price and the fair market value of the Common Stock at the date of surrender. All options terminate 10 years from the date of grant if not exercised. With the adoption of the 2005 Equity Incentive Compensation Plan at the 2005 Annual Meeting, no further grants will be made under the 1985 Plan, although unexercised awards granted in 2004 and prior years remain outstanding.

A summary of option activity under the 1985 Plan as of September 30, 2006, and changes during the period then ended is presented below:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Life (Years)
Outstanding at December 31, 2005	103,997	\$ 18.24	5.07
Exercised	(10,155)	13.94	
Cancelled	(4,474)	20.34	
Outstanding at September 30, 2006	89,368	\$ 18.52	4.44
Exercisable at September 30, 2006	39,331	\$ 18.29	3.85

The options outstanding as of September 30, 2006 are set forth below:

Exercise Price	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)
\$12.50-\$14.99	9,429	\$ 13.20	1.09
\$15.00-\$17.49	29,615	16.29	3.71
\$17.50-\$19.99	18,583	19.45	5.25
\$20.00-\$22.49	31,741	21.63	5.65
Outstanding at September 30, 2006	89,368	\$ 18.52	4.44

Compensation cost resulting from stock options and stock appreciation rights granted under the 1985 Plan is based on

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

the intrinsic value of the award, recognized over the award's vesting period, and remeasured at each reporting date through the date of settlement. The total compensation cost recognized for the nine months ended September 30, 2006 was \$81,196.

The 2005 Equity Incentive Compensation Plan (2005 Plan) permits the grant of stock options, restricted stock awards and other stock incentives to key employees and all non-employee directors. The 2005 Plan provides for the issuance of up to 872,639 shares of the Corporation's Common Stock, including both performance and nonperformance-based restricted stock. Performance-based restricted stock awards vest at the end of a specified three year period, with the ultimate number of awards earned contingent on achievement of certain performance targets. If performance targets are not achieved, all or a portion of the performance-based awards are forfeited and become available for future grants.

Nonperformance-based restricted stock awards vest ratably over a three year period and nonperformance-based restricted stock units (granted to non-employee directors) vest over a one year period. It is the current intention that employee grants will be performance-based. The 2005 Plan provides for accelerated vesting in the event of death or retirement. Non-employee directors also may elect to defer a portion of their cash compensation, with such deferred amount to be paid by delivery of deferred stock units. Outstanding awards were granted at fair market value on grant date. The number of shares of Common Stock which remain available for future grants under the 2005 Plan at September 30, 2006 is 845,878 shares.

The Corporation pays dividends and dividend equivalents on outstanding awards, which are charged to net assets when paid. Dividends and dividend equivalents paid on restricted awards that are later forfeited are reclassified to compensation expense.

A summary of the status of the Corporation's awards granted under the 2005 Plan as of September 30, 2006, and changes during the period then ended is presented below:

Awards	Shares/ Units	Weighted Average Grant-Date Fair Value
Balance at December 31, 2005	8,630	\$ 28.35
Granted:		
Restricted stock	13,025	34.32
Restricted stock units	4,000	33.21
Deferred stock units		