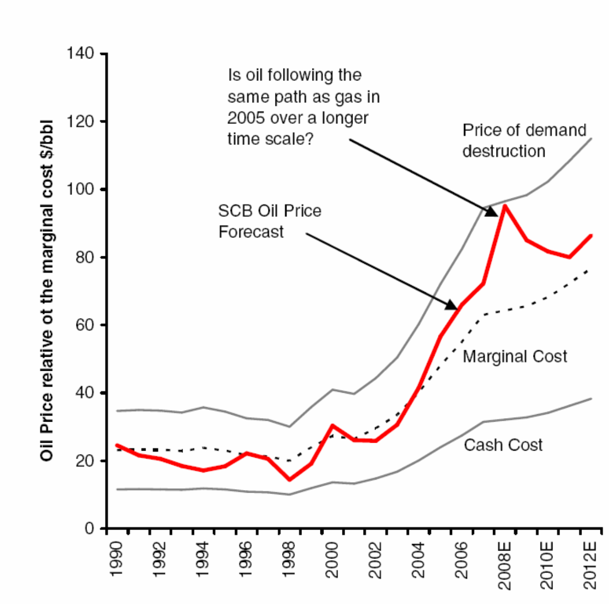
Sionna
Investment Managers

The Value in Resources

Many claim that the resource sector is in the midst of another bubble, as crude oil, copper, and wheat prices reach multi-decade highs and these commodities attract record financial investment. Returns in the energy and materials sectors have been strong and market weights have grown; however, the valuations do not appear excessive. Rather than discounting continued rapid growth, investors appear to fear an imminent collapse, which has left multiples of current earnings and cash flow at modest levels. While Sionna recognizes that speculative pockets have emerged in the resource sector, we continue to find good value in specific stocks in the Energy and Materials sectors. Our stock-specific research is also supported by broader trends, such as robust demand driven by growth in emerging markets, lagging supply for key raw materials, and rising production costs.

The fundamentals for crude oil are sound, based on Sionna's thesis that the price of oil in the long term should be defined by the cost of producing a new additional barrel of oil, or marginal cost. The marginal cost of production is estimated at approximately US$63 per barrel today, which is essentially the cost of bringing the oil sands into production, and is expected to rise to US$86 per barrel by 2012 (Source: Sanford Bernstein research, 2008). The marginal cost of oil has been rising over time as global demand continues to increase but oil reserves and supply are finite, leading to an imbalance. The oil reserves that producers are extracting today are oil shale and tar sands, which are messy and expensive to extract. Tar sands require billions of dollars in capital investment and take years from initial investment to actual production. As a result, the cost of supplying oil continues to increase. The chart below shows the rising marginal oil cost since 1990.

Oil prices relative to the marginal cost



Source; Bloomberg, Corporate Reports & Bernstein Estimates

In the short term, oil prices can occasionally deviate from the cost of producing the additional new barrel. However, in the long term, the price of oil should revert to the mean and reflect this cost. The upper and lower bound of oil price is governed by supply and demand. The upside in oil prices will be limited by demand destruction, or the price at which consumers begin to reduce their usage of oil. The downside will be limited by cash cost, or the price at which suppliers begin to lose money selling a barrel of oil. The increase in the cost of supply has driven the upward trend in commodity prices – a trend that

Sionna expects will continue in the future.

Current valuations for energy companies are attractive. Energy stocks are arguably reflecting US$60 per barrel, not the current US$100 per barrel price, which implies that the stocks are not expensive at current levels. It is also worth noting that, while the price of crude oil increased by 65% in 2007, the Energy sector was only up 5% during the same time period. In other words, investors are not including current strong crude oil prices in stock valuations. Natural gas prices were weak in the second half of 2006 and in 2007, trading as low as US$5.00 per mcf. Given that the marginal cost of production of natural gas is estimated at approximately US$7.50 per mcf, Sionna concluded that the natural gas markets offered an attractive investment opportunity. As a result, we accumulated positions in gas-levered producers and drilling companies throughout this time period.

We value materials stocks by considering long-term average commodity prices, not current market prices. These average commodity prices incorporate the high prices of the current environment, as well as the low prices experienced in the 1990's. We use these long-term average commodity prices to calculate the sustainable earnings for each business, and then apply historical price to earnings multiples to generate our target stock prices. Using this methodology, we have found numerous names in the Materials sector that reflect fair to good value. The valuation appears even more appealing when considering that the excess cashflows realized during the strong commodity pricing environment of recent years has resulted in certain names in our portfolio boasting up to 40% of their market capitalization in cash. As bottom-up stock pickers, we are comforted by these defensive qualities, especially given the ongoing financial crisis. On a stock-specific basis, we invest in companies such as Teck Cominco and Methanex, which are trading at price to earnings multiples of 11.0X and 6.6X, respectively, in contrast to a stock such as Potash, which is trading at a price to earnings multiple of 44.0X. Thus, even though Sionna is invested in a speculative sector, we are invested in the more conservative parts of the sector.

Sionna remains confident in our investments in the Resource sector. Our investments are based on bottom-up, fundamental analysis and are also supported by the top-down macro view that industrialization and urbanization of emerging economies is a secular trend that will drive the sector in the long term. Sionna is invested in the resource companies that continue to show good fundamental value. Many resource stocks currently reflect oil and metals prices that are significantly below current commodity prices. Also, when we use history as a guide, we find that real assets behave conversely with financial assets. Given our continuing concerns regarding the financial system, we think that real assets (i.e. resources) should perform relatively well. As a result, Sionna remains bullish on the Energy and Materials sectors.

Teresa Lee
Portfolio Manager
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