

Thursday May 24th, 2012

Good morning,

After our Financial Market Review on May 3, 2012, we had an opportunity to take questions from attendees and address a range of topics. There were a variety of questions brought up: below are three that caught our attention. For detailed notes from the Review and for all of the questions, stay tuned for our outbound email.

1. You define small caps as not necessarily as risky as we might think. But, implicit in that is your definition of risk. As an example, one of the risks with small cap is the inability to raise capital. How do you handle risk and how do you define it?

Teresa Lee: Internally Sionna defines risk as the possibility of permanent capital loss. We use standard deviation (the industry standard measure of risk) and look at the downside and whether we will lose money on the investment. Sionna generally likes to buy businesses that generate significant free cash flow, such as Pulse Seismic Inc., and that can self-finance their own capital investments. We ask ourselves: if this company wants to grow, can it finance on its own or does it rely on the capital markets? If the company does rely on the capital markets, we generally would avoid it.

2. Are we looking forward to another 12 years of a sideways market given the financial crisis in Europe and the serious financial problems that the American economy has?

Kim Shannon: Just putting it in a modern context, Japan is arguably now in its 21st year of its sideways market, so we have an example of a significantly sized major market that in the modern sense has been sideways for 21 years. The hallmark is that price-to-earnings multiples get down to single digits, which you now have in Japan – we aren't there yet. In the past, we've also seen that you tend to get down to single digits and then generally go one more economic cycle before there is a full major bull market run. So, the markets, I presume, will be subdued in the next five years or so.

3. What is your current view on natural gas?

Teresa Lee: We view the marginal cost of supply to be the intrinsic value of commodities. The marginal cost of natural gas is about \$5 per thousand cubic feet (MCF) versus the current spot price of about \$2.50 per MCF. When we look at the major North American shale producers, the lowest all-in cost is \$3.50 per MCF. Clearly no one is making money at these levels. We continue to think that natural gas is very inexpensive, is likely to rise in value, and thus we believe that it is a good investment opportunity today.

Kim Shannon: We are also seeing some very interesting responses because we are now in what would be considered an economic equilibrium. Nobody is making money selling gas at \$2, so there will be both a supply and demand response. Because gas is so cheap on an energy-equivalent basis, people are converting to gas, but there is always a lag and a delay. So, you have supply going down over time and you have demand going up until you find that equilibrium. It looks like most of the shale producers seem to need at least \$4.50 or \$5 all-in to break even and earn an ordinary economic profit. The stock prices are not reflecting \$5 MCF, so there will be an opportunity. That's our view and we are patient investors; we are used to having to wait and see.

Teresa Lee Discusses Sionna's Small Cap Strategy on BNN

Portfolio Manager Teresa Lee discusses the small cap market and Sionna's current holdings on BNN's *Business Day* (May 23rd). Click [here](#) to watch.

The Sionna Team



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