Patient Capital Management Inc.

patiently creating wealth™

www.patientcapital.com

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So much for peak oil!

Peak oil refers to the theory that oil prices would rise ever higher because of increasing demand and diminishing supplies. Furthermore, it was argued that finding new sources of oil was becoming more and more expensive. The per barrel cost of finding and developing oil in frontier areas such as the Arctic and other very remote locations would raise the price of oil to $200 per barrel in the near future. Of course this view was at its most popular as energy prices were on an upward trend and near their peaks.

As the graph below from *SeekingAlpha.com* indicates, peak oil seems to have been turned upside down. The price of oil has fallen from just over $100 per barrel in early 2014 to approximately $50 at the end of the year.

This dramatic decline should remind all of us that no matter how attractive, eloquent and interesting the people and the arguments may be; a healthy dose of skepticism is in order when explanations are put forth to justify rising prices. The fact of the matter is that the "invisible hand" of Adam Smith's market forces **always ensure that reversion to the mean prevails!**

The fall in oil prices has resulted in a corresponding drop in the share prices of energy related businesses. As you would expect we have spent a considerable amount of time rummaging through the rubble. Fortunately, we have found some gems amongst the ruins and deployed some of our capital to energy companies that we believe are well capitalized industry leaders and that provide the potential for substantial returns.

Some portfolio managers believe that commodity companies are not attractive businesses and therefore should always be avoided. While we would agree that for the most part commodity companies are low return businesses we believe that under the right circumstances they can provide an excellent rate of return over a five year holding period. We look for several important factors before we purchase a commodity related business:

- √ A long life and high quality resource base
- √ Low cost operations
- √ A very strong balance sheet
- √ Conservative and experienced management
- √ Shares trading at a substantial discount to our estimated net asset value

It is important to note that we calculate our net asset value based on **the long term inflation adjusted price of the commodity in question**. There are no peak oil like theories at PCM! Our process leads us to invest in companies that can sustain a prolonged period of low commodity prices and that we purchase them at prices trading below our estimated net asset value. Our investment philosophy also ensures that we sell above net asset value and realize our profit.

While we are pleased to have deployed some of our capital in the energy sector we are still having difficulty finding new investments outside of this group. The broader based equity markets in both Canada and the United States remain very expensive. The companies that interest us still sell substantially above their intrinsic value.

The reason for this overvaluation is a policy of historically low interest rates by central banks around the world. In the search for higher returns investors are ignoring some very serious risks. To highlight just a few:

Greece has elected a new government that plans to end and reverse the austerity measures that have been imposed on the country by the European Union. Furthermore, the new government plans to renegotiate its debt repayment agreements. Not surprisingly these proposals have not been well received. Negotiations are currently underway; should an agreement fail to be reached Greece may have to withdraw from the European Union and give up the euro as its currency. The ramifications of such an outcome are potentially very serious and may have far reaching consequences for the global economy and financial institutions.

The situation in the Ukraine is intensifying. Russia seems intent on reclaiming what it feels is lost territory while the United States and its allies feel an obligation to protect developing democracies in Eastern Europe. The West and Russia are potentially on a collision course that could rattle financial markets.

Large developing world economies are slowing dramatically. Brazil, Russia and China are all in various states of turmoil. Russia is experiencing a deep recession and currency crisis due to sanctions imposed by the West and the fall in the price of oil. Brazil has been similarly impacted by low oil prices and is experiencing political instability and China's growth has fallen from historical highs.

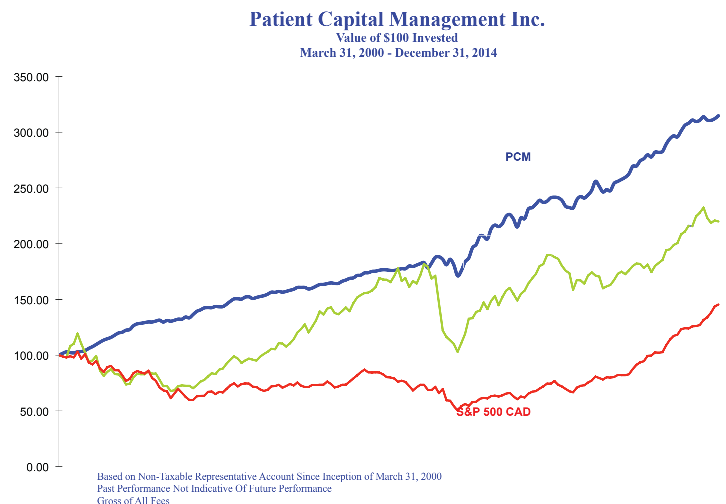
Closer to home the Canadian economy will definitely be impacted by the fall in energy prices. The economy is already exhibiting weakness with low economic and job growth. In addition, real estate prices are at all-time highs fuelled by record household debt levels.

The aforementioned risks have been apparent for some time. However, market participants are ignoring or "pricing out" risk from both the fixed income and equity markets. Fixed income markets offer very low current income and a very unattractive risk/return trade-off. From current historically low levels the probability that rates will increase is high and thus the liklihood of capital losses in the fixed markets is also high.

Equity markets are also ignoring risk as evidenced by the following:

- √ P/E Multiples and other valuation metrics are at elevated levels
- √ The S&P 500 has posted double digit returns for three consecutive years; only the second time in forty years that this has occurred
- √ The market weighted S&P 500 increased 13.7% while the Value Line Index, a more representative index of the average stock increased by only 3.1%
- √ Equity markets have experienced little volatility and there has been very little difference in the returns amongst individual stocks
- √ Momentum investing has taken root sending larger capitalization stocks ever higher; particularly as investors move into passive indexing strategies and new ETF products

These conditions are very similar to those in early 2000 when we first started Patient Capital. Our investment portfolio was the same then as it is today; a large percentage in short term government securities and very little equities. Like today, we could not find many investments that met our criteria for quality and value; we felt that it was critical to keep our capital safe and patiently wait for far more favourable opportunities. While we can't predict the future, and there are no guarantees, we believe that the next fifteen years are likely to produce the same outcome as the past fifteen years.



Patient Capital continues to grow through your increased allocations to us and by your kind referrals. We appreciate your continued support and are truly humbled by the trust and confidence that you place in us.

Vito Maida
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