Seymour Investment Management

January 13, 2015

Equity markets in North America recorded another positive year in 2014. In the U.S., the S&P 500 Index delivered a total return of 13.7% while in Canada the S&P TSX Composite Index generated a total return of 10.6%, underpinned by strong corporate earnings growth. Global economic growth remains positive, albeit at somewhat modest levels that are lower than consensus expectations, with various geographic disparities. Inflation and interest rates continue to be at very low levels.

The steep and sudden decline in oil prices dominated financial headlines and investment performance in the fourth quarter of 2014. In the summer of 2014, crude oil traded above $100 per barrel and today it's trading below $50. A change of that magnitude in the price of crude oil has far reaching implications for economic growth and for the value of a wide range of businesses. The sharp decline in the oil price was not an event that we considered at all likely to occur. As a result, our returns were negatively impacted, particularly in the most recent quarter.

At Seymour, we have largely avoided direct exposure to most commodity or resource sectors for a variety of reasons. This is not due to some unique insight into commodity markets but rather, simply because of the evidence that most resource sectors and companies have historically been sub-par investments over long periods of time, especially when compared to their non-resource counterparts. Of course there are notable exceptions to this trend. Spectacular investment successes in mining and energy do occur and they generate investor interest in those sectors. However, the seductive appeal of the occasional exponential return probably entices many investors to overlook the below average, long-term returns which have characterized the resource industries.

We do, however, have investments in companies that provide various services to the energy industry including transportation (pipelines), hydrocarbon processing, waste treatment, remote workforce housing and other energy related businesses. In contrast to the sub-par, long-term track record of energy producers, many energy related service providers (i.e. pipelines) have produced excellent long-term track records of shareholder value creation. Despite the recent sharp correction in oil prices, we continue to believe that many of these energy related businesses will be excellent, long-term investments.

The dramatic decline in crude oil prices (see chart below) likely occurred for several reasons. Worldwide demand for oil has been somewhat sluggish as economic growth in China and other emerging markets has slowed. More importantly, there has been a steady increase in crude oil supply, in Russia and particularly in North America from shale oil and oil sands. The increase in new

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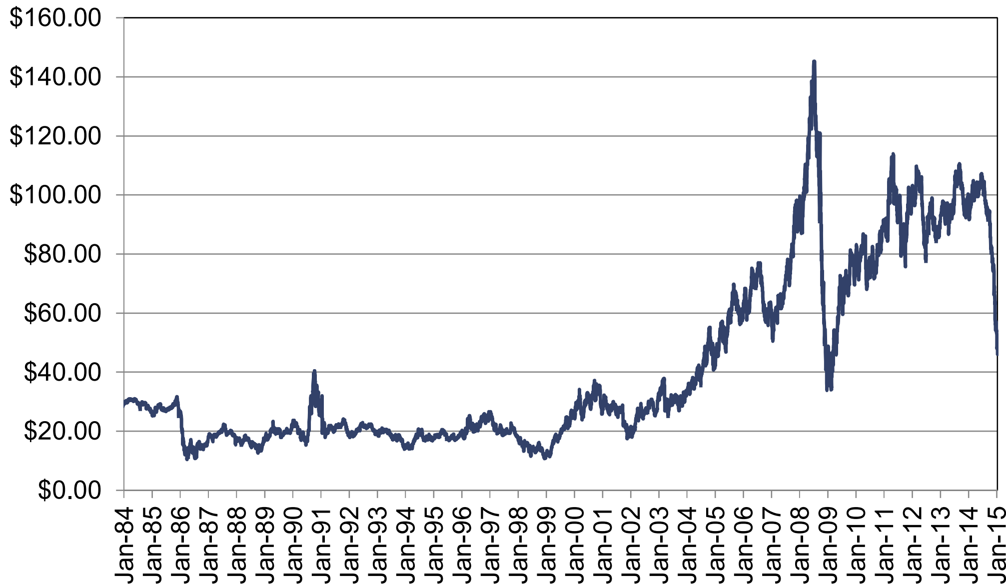
supply from non-traditional suppliers has also elicited a response from OPEC countries to the effect that they will be aggressive in maintaining market share at the expense of crude pricing.

NYMEX WTI Crude Oil (US$/bbl) Historical Pricing (1984 – Present)



Source: Peters & Co. Limited, Bloomberg

Our approach with any commodity is to estimate the marginal cost of production and to use that as a guideline to estimate the long-term, equilibrium price. The marginal cost of production is an estimate of the cost to bring the next, most economic (or marginal) project on-stream. The price of most commodities cycles around its marginal cost and changes in technology or other factors can move the marginal cost over time. In North America, the marginal oil projects are shale oil and undeveloped oil sands projects. It seems investors, including us, became complacent about a marginal cost structure for crude oil in the $80/bbl range (reflective of new projects in North America). However in retrospect, crude oil presents some difficulty in this respect because so much of it is produced in the areas of the world with limited financial disclosure (i.e. the Middle East) making it difficult to accurately estimate marginal costs. It may be that incremental production can be brought on-stream in areas such as Saudi Arabia at prices lower than the $80 level which seems to represent the marginal cost in North America. It may also be that there is spare capacity to produce crude oil in these regions like Saudi Arabia which could maintain supply even without incremental, new production. However, it seems likely that the cure for low oil prices is low oil prices.

There is a natural decline rate to producing oil fields which varies widely by region but is generally assumed to be at least 10% worldwide. Even if there is existing spare, productive capacity, eventually the natural decline in oil production creates a shortage without additional investment in new production. Similarly, lower crude oil prices stimulate demand (consumers drive and fly more and buy larger vehicles that consume more fuel). Low prices also discourage consumers from substituting alternative fuels (hybrid or electric vehicles). It is interesting to reflect back a few years

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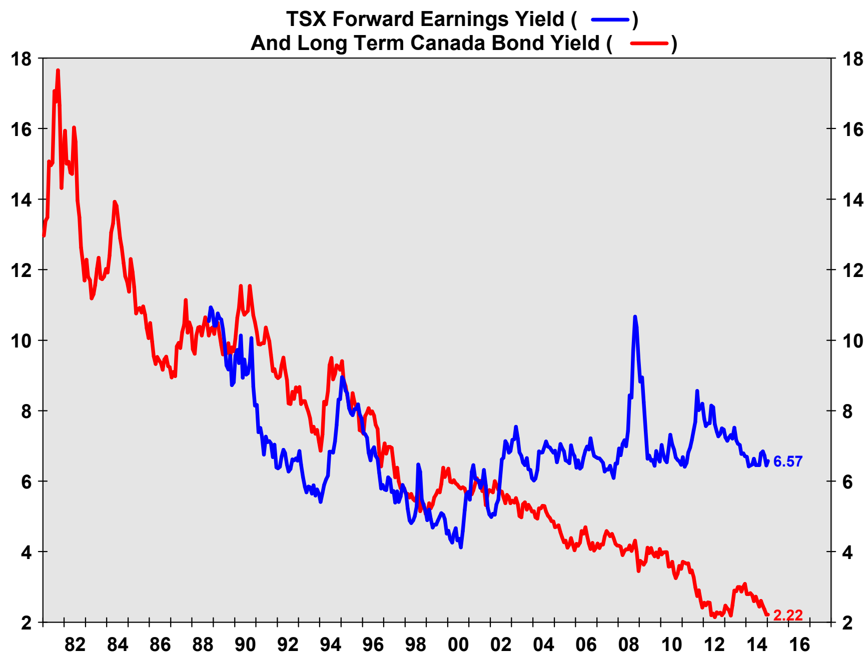
when the prevailing theory on crude oil was that the world was rapidly running out of cheap oil. The so called “Peak Oil” theory as espoused by Matt Simmons and others had a lot of followers believing that crude oil prices were destined to stay above $100 per barrel in perpetuity.

Our view is that over the long term, crude oil is likely to be closer to $80 (the marginal cost of new production in much of the world) than to current levels but admittedly the timing of that move is very uncertain. We continue to invest in a few well financed companies with sustainable competitive advantages and good long-term growth prospects, even where their major customers are energy producers. Like all equity investments, there are some risks to this strategy but we think the potential returns of these investments offset the [medium-term commodity price] risks.

The good news for equity investors is that the crude oil price decline is a net positive for the U.S. economy. Lower gasoline prices act like a tax cut for consumers, stimulating demand without the negative fiscal consequences of a tax cut. We believe the U.S. economy was already poised for some very positive economic growth with a recovering housing market and manufacturing helping boost employment growth. Lower gasoline prices will accelerate that economic growth and provide a good backdrop for corporate earnings growth. Of course there will be some negative impact on the earnings for energy producers and service companies, but the net impact will very positive for corporate earnings.

The other development that surprised us in 2014 was the continuation of historically low interest rates. We have been sounding the warning bell to our clients about the probability of higher interest rates for some time now. As shown in the chart below, the yield on long duration, Canada bonds is now barely over 2% (see chart below). Over the last century, that yield has averaged more like 5%, which is still well below the average annual return from owning stocks (closer to 10%).



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Source: TD Securities

In our view, investors have become complacent about the prospects of a benign inflationary environment. The best return that a long term bond can generate for an investor that holds it to maturity is just over 2% and that's before taxes, fees and the loss of purchasing power from the (eventual?) ravages of inflation. Very few strategists are expecting a return to inflation any time soon but investors should remember that even a year ago, almost nobody was forecasting $50 oil.

The earnings yield on stocks (and its inverse the price to earnings multiple) is around the average historical level. While the drop in crude oil prices may create some temporary challenges for corporate earnings in the energy sector and related companies, we believe the economic environment remains constructive for earnings growth and that equity valuations are reasonable. For most investors, the long-term hurdle rate for owning stocks remains shockingly low at 2%. To put that in context, over the last ten years, stocks in Canada have delivered a total return of 8% per year and that 10-year period includes the worst year for stocks in many decades (-37% in 2008). For these reasons, we continue to favour equities over fixed income investments and expect patient, long-term investors will be rewarded with equity returns that are commensurate with earnings growth.

As always, please don't hesitate to contact any one of the Seymour team with questions or concerns. We wish you a happy, healthy and prosperous 2015.

Warm regards,

The Seymour team

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