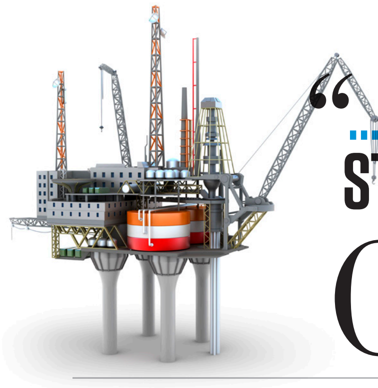
Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JANUARY 2, 2015



"... AND THE INVESTOR AWARD FOR STORY OF THE YEAR GOES TO... OIL PRICES!"

WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL

Arguably, no event in 2014 continues to be more talked about than the huge slide in oil prices. That's because no commodity like oil has the potential to change the economic landscape. The million dollar question is whether the sharp drop in oil from $115 to under $50 is net positive, net negative or net neutral for the economy as a whole. Judging from the volatility in the stock market, it appears that investors with "the glass, half empty" view are winning.

At Frontwater, we feel differently. Oil is an essential commodity, which means that the cost of living just got more bearable – and the global economy got a shot in the arm as well. The silver-lining opportunities and possibilities far out-balance the downside.

Only a few months ago, $100 dollar oil was supposed to be the "new normal with the emergence of dozens of new industrializing nations and

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population growth. Demand for crude was forecasted to grow by 1.4 million barrels a day in 2014. Then sometime around June, everything got fuzzy. Industry slashed its oil usage; the U.S. pumped record numbers of barrels to become a net oil exporter thanks to new extraction techniques; and fuel-efficient cars drove down gasoline consumption.

Meanwhile the Saudis saw an opportunity to drive out the little guys who couldn't survive on sub-hundred-dollar oil. Typically OPEC hits the brakes on production to support prices when demand drops. But this time, they kept pumping, and pumping, and flooding the market which drove prices down...way down.

It is a gambit on the part of the Saudis intended to return oil prices back to the $100 level but only after a rash of small suppliers (ie. American shale producers) are knocked out. History would be on the side of the Saudis and already we are starting to see a few of the smaller players go belly up while large cap companies announce their intention to cut capital spending.

For those of us running diversified portfolios and holding energy exposure, it hurts to watch a number of well-run companies get carried down. Oil equipment manufacturers and service companies, like National Oilwell Varco (NOV) and Savannah Energy Services (TSE: SVY), have been hit hard by the slide in prices. But these are solid, well-managed companies, and lower stock prices may present a value situation.

The good news is that there is nothing better than lower oil prices for the stock market and the US economy. Already, 3rd quarter GDP in the US grew by more than 5% and the global economy is likely to follow suit in 2015. As for the consumer, they are only starting to benefit from lower gasoline and heating bills. But we expect the fringe benefits to begin rolling in soon enough too. That extra buying power for both individuals and industry, combined with negligible interest rates and relaxed monetary policies, should finally be the magic bullet that propels the global economy forward in 2015.

A Contrarian View:

HOP ON THE COMMODITY BANDWAGON (WHILE OTHERS PARACHUTE OFF)

“Chaos brings opportunity.” Those sage words were written by the ancient Chinese general-strategist-philosopher, Sun Tzu, in *The Art of War*. He would probably offer the same advice to China today as the world’s second largest economy is in the midst of its weakest expansion in 24 years.

Truth be told, the downhill trend might well be predictive – but it might not be predicting more of the same.

It is also the same suggestion I offer to investors who are looking disparagingly at the commodities market, which just posted its fourth straight annual decline and is on its longest losing streak in 23 years.

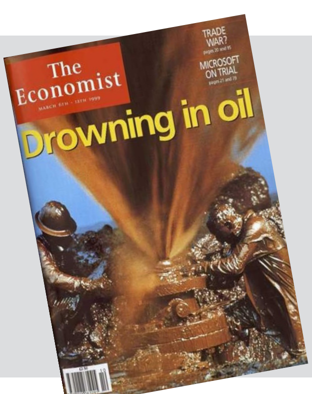
Oil stole most of the headlines this past year as it led the way with an across-the-board plunge. But that was not the only commodity to take an amusement-park, eyeball-popping nosedive. Iron ore prices fell 42% in 2014 slumping to its lowest levels since the 2008 global financial crisis. Likewise, copper and lead were down more than 14% and 5% respectively.

Only a couple of months ago, most analysts were certain that commodities like oil and iron ore could only move higher. “Peak oil” was the official term referring to the diminishing level of oil resources throughout the world.

Of course, it is absolutely amazing to watch the so called expert analysts flip flop from one extreme viewpoint to the next. Today, many of these same Chicken Little analysts are running around playing the “trend is your friend” game; predicting that the current downward direction is the direction of the future. Truth be told, the downhill trend might well be predictive – but it might not be predicting more of the same.

Commodity prices are now – and always have been – cyclical. As usual though, when prices correct, they tend to over-correct before they find their level of intrinsic value in the marketplace. In the meantime, low commodity prices act as a stimulus to the economy by lowering the cost of putting food on the table and other essential household costs. History tells us that they should gain strength as household incomes begin to feel the benefit from a truly rebounding economy.

Remember Apple? A couple of years ago the stock was marching towards $700, and then the shares went into free-fall for 18 months. Analysts got out their knives and started slashing forecasts, and then the share prices abruptly turned back up. The same holds true for commodities.



The March 1999 cover of the *Economist* reads “Drowning in Oil” and might as well have been written today. At the time oil had fallen from $40 to $17 and the magazine was predicting it could fall as low as $5. Sure enough, the *Economist* could not have been more wrong. Oil prices bottomed out within a couple of weeks. By 2001, oil had doubled to $40 and would continue its upward trend for the next 7 years. Predicting commodity prices is often a futile exercise to do. Investing in cyclical dips is not.

THE VALUE INVESTOR'S PLAYBOOK

BHP BILLINGTON
(BHP: $47.50; DEC 31, 2014)

CHEVRON
(CVX: $111; DEC 31, 2014)

NATIONAL OILWELL VARCO
(NOV: $65.53 DEC 31, 2014)

The gates of Hell in Dante's *Inferno* have a sign that reads: "Abandon all hope, ye who enter here." Right now that might feel like good advice for investors in commodity oriented stocks. In all likelihood commodity prices are still several weeks and perhaps months away from hitting bottom. But is it economics or investor fear driving these stocks lower.

Let's take a look at a couple of strong commodity oriented companies that might keep you from running with the bears. We believe we are starting to see attractive and compelling valuations for any number of commodity-oriented stocks that are trading at or near their book values and at EBITDA multiples under 6.

BHP Billington has a market capitalization of $135 billion and is one of the world's largest major commodity producers. The company mainly focuses on low-cost, long-life assets in 5 key areas: petroleum and potash, copper, iron ore, coal and aluminum, and nickel.

The company has a very strong balance sheet and carries approximately $40 billion of debt – a very reasonable and manageable amount for a company of that magnitude. As a low-cost leader, BHP is well positioned to survive the recent downturn in commodity prices.

In fact, their long-term game plan reads much like that of the Saudis – flood the market in the short term, drive out the high cost marginal players in the long term, and return commodity prices to last year's levels.

Of course, this strategy takes time to play out. For long-term investors with patience, the stock seems reasonably priced. It pays a dividend of 5.2% with a reasonable dividend payout ratio of 46%. It generates a substantial amount of free cash flow and only trades at 5 times EBITDA. And it has the financial capacity and deep pockets to ride out the current storm.

PRICE COMPARABLES

	BHP	CVX	NOV
Price (As of 12/31/2015)	$47.50	$111.00	$65.53
P/E Multiple	9.1	10.0	10.7
EBITDA Multiple	5.1	5.4	5.9
Dividend Yield	5.20%	4.00%	2.90%
Payout Ratio	46%	38%	24%
Debt To Equity	40%	16%	15%

Admittedly, BHP is not for the faint of heart or short-term opportunists. In the end, we believe everything will work out – but there will be volatility over the next year.

Another commodity stock that should be on the value investor's radar is Chevron. Chevron is one of those dividend stalwarts that has weathered wars and recessions over the decades. As noted in previous newsletters, we love those dividend-paying companies that continuously lay those golden eggs.

Chevron is an energy giant that barely needs an introduction. The company is the second largest in the US energy sector, after Exxon Mobil. It is a Dividend Champion that has raised its dividend for 27 consecutive years, with a 5-year dividend growth rate of 9%. The current yield of 4.0% provides a historically remarkable entry point for long-term investors. While the current downturn in oil and energy prices provides downward pressure on stock prices from declining earnings, it also provides an excellent buying opportunity.

With a market capitalization of over $200 billion, the company maintains a very manageable amount of debt at $25 billion. At this level, the 4.0% dividend is more than secure and the company is more than credit worthy to sustain a downturn in oil prices.

Like BHP, Chevron is nicely positioned in this low-price environment.

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FRONTWATER SERVICES

We have the expertise to protect our investors from currency fluctuations on US dollar denominated assets. Our investors can invest in markets outside Canada without having to worry about volatile foreign exchange rates.

SERVICES

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- Assessing your Risk and Investment Profile
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- Structuring of Family Wealth
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- Business Continuation Planning
- Protecting US$ Investments against Currency Risks
- Hedging against Extreme Events

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- Commodities
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- Structured Products
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- Individual Pension Plans (IPPs)
- Locked-In Retirement Plans (LIRAs)
- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

PLAYBOOK

CONTINUED FROM PAGE 3

low cost production, integrated operations, and strong balance sheet should keep the company on solid footing while helping to improve its worldwide positioning for the future.

Finally, National Oilwell Varco is a best of breed U.S. company that provides oilfield services, equipment and parts used in oil and gas drilling and production. Over the last fifteen years, the stock has increased almost 10 fold. Meanwhile profit margins have nearly doubled.

The company is about a tenth the size of Chevron. It has a market cap of $27 billion, manageable debt of $3 billion and a secure 2.9% dividend yield.

At its current price of $65, NOV trades at very similar multiples to that of Chevron:

- 1.2 times Book Value
- 10.7 times trailing Price Earnings
- 5.7 times EBITDA

While commodities have shed most of their "hedge" value, their intrinsic value as essential resources for our economy and society will always keep them afloat. Farms will never go out of style because they can't, and neither will oil or other commodities that households and industry depend on.

Guaranteed Investment Certificates (GICs)

WHY INVEST IN GICS?

GICs are secure investments that guarantee your initial principal investment, while earning a fixed rate of interest over their lifetime. GICs offer predictable income and are the foundation of many balanced portfolios.

HIGHER RATES, SAME RISK

As a deposit broker representing over 30 financial institutions across Canada, we are able to offer our clients personalized service at a lower cost. This means that the savings get passed along to you through higher interest rates with the same principal guarantee that all GICs provide.

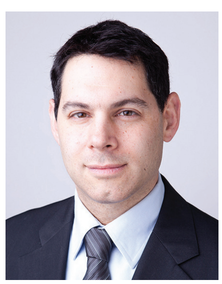
BENEFITS OF OUR GICS:

In addition to offering CDIC protected GICs which provide protection up to $100,000, we also offer GICs with:

- UNLIMITED deposit insurance protection by:
  - ✔ CUDIC of British Columbia
  - ✔ Deposit Guarantee Corp. of Manitoba
  - ✔ CUDGC of Alberta
- 1%-1.5% higher than average rates (see table*) from over 30 Canadian institutions

	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.08%	1.95%	1.95%	1.94%
2yr GIC	2.20%	2.20%	2.20%	2.10%
3yr GIC	2.27%	2.20%	2.20%	2.20%
4yr GIC	2.50%	2.35%	2.35%	2.35%
5yr GIC	2.70%	2.60%	2.60%	2.60%

*rates subject to change



JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). He has more than 15 years capital markets experience.

Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Commodity Trading Adviser, and Exempt Market Dealer.

FRONTWATER CAPITAL

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