

# PALOS

## CONTENTS

Choppy markets	1
The state of Canadian energy	1
ESG investing	2
The investment thesis	3
Palos Contact Info	4

## The Palos - Mitchell Report

OCTOBER 14, 2019

*By William Mitchell, B Comm., CIM  
Portfolio Manager*

### It's been a choppy year

The third quarter is now 'in the books' and the market action for 2019 is best described as 'choppy'. As of September 30<sup>th</sup>, we find North American stocks virtually unchanged from twelve months ago (Sept. 30, 2018). Over this span we've seen marginal gains in the Dow Industrials (+ 1.73%), the S&P500 (+ 2.04%) and the TSX Composite (+ 3.64%), and a miniscule decline in the NASDAQ Composite Index (- 0.58%). Geopolitical 'hotspots' (North Korea, Middle East, Venezuela, Hong Kong and now Turkey's incursion into Syria), political upheaval (impeachment, Brexit) and economic concerns (China trade, tariffs, negative interest rates) have shaken investor confidence. Indeed, 2019 has been a challenging year.

### The state of Canadian energy

It's well documented that performance in energy has lagged the performance of peer sectors for most of 2018 and 2019. While many analysts remain bearish on the sector, we believe in doing our own homework and drawing our own conclusions. This not only separates us from the pack but frees us from any bias that may exist in research done by others.

Palos recently attended the annual National Bank Canadian Energy Conference held in Montreal. Gatherings like these allow us the opportunity to meet with trusted industry analysts and senior management from companies in the Canadian energy sector. The value is, we get to meet with and pose direct questions to management of the companies we invest in.

Most of the analysts and executives we spoke with were very clear when reflecting to us that despite a 'challenging environment', the financial health of the sector is 'better than it's been in years.' Ironically, challenges faced by our oil patch has mandated management to show greater vigilance with regards to restraining capital expenditures, improving operational efficiencies and addressing environmental concerns. The results of these efforts are stronger balance sheets, reduced carbon emissions and improved sustainability for the long run.

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## What's ESG investing? (Environmental, Social, Governance)

According to information supplied by the *Energy Information Administration*, global demand for oil is projected to grow steadily through 2040. The reality is, we live in a global community and as emerging economies evolve, demand for oil is destined to grow. We've recently seen that climate change issues are important to most Canadians and while we should do our part, we cannot overlook one simple question. As Canadians, are we willing to unilaterally undertake aggressive policy changes that are certain to harm an extremely important sector of our economy, while most of the world's oil producers remain bad actors by ignoring their carbon emissions footprint?

Canadian oil producers have become world leaders with regards to ESG investing. The **environmental** aspect takes into consideration such factors as reducing the carbon footprint, better waste processing, land rehabilitation and adherence to environmental laws. Contrary to the rhetoric being disseminated by some special interest groups, Canada's energy companies are among the most progressive on the planet. A consistent theme shared by the management teams was their commitment to action on meeting emissions reduction targets and reducing their environmental impact.

**Social** criteria address such matters as fair and equitable treatment of employees, workplace safety and community involvement. As an example, progress has been made in engaging First Nations by offering potential partnerships in pipelines and other infrastructure projects. This could create significant employment opportunities in, profit-sharing potential and joint responsibility for environmental stewardship.

The **governance** part of the equation addresses issues like fairness in election of board members, transparency, and assurance of ethical business practices. Again, virtually all the executives we met with expressed a genuine determination to create and implement action plans designed to improve diversity and gender equality at the board level.

At the BMO energy conference held in May of this year, a comprehensive publication on the state of ESG in Canadian energy reported that our companies are among the most progressive on the planet. It's given that many socially minded investment funds, endowments and sovereign wealth funds are increasingly employing ESG principles when evaluating investment options. As such, it makes perfect sense that companies that engage in such practices should attract investment dollars versus those that don't. As ESG investing mandates become mainstream and investors become more educated, Canadian energy companies should ultimately be rewarded, not punished.

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Portfolio Manager*

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## **The investment thesis**

There's no denying that investing in energy has been a painful experience over the last 18 months. As significant amounts of investor dollars have moved away from the sector, we should keep two thoughts in mind. The first is the widely held misbelief that oil consumption is in decline. This is a matter of wishful thinking on behalf of the anti-oil movement, as forecasts point to growing demand for the foreseeable future. The reality is we do not have the infrastructure, nor an economically affordable technology to replace oil. This will take time. It will also require a coordinated global willingness to address the issue.

Secondly, the best investment ideas are often a result of behaving sensibly while others panic and irrationally sell. The facts are, many of these companies generate impressive free cash flow, are focused on debt reduction, many pay sustainable dividends, and several are using cash flow to buy back their shares. And, as alluded to above, our energy companies are recognized as the most socially responsible in the world.

In my opinion these are all positives that are being overlooked by the markets. Sometimes, taking a position that runs contrary to the "crowd" makes a lot of sense and I firmly believe that making a case for Canadian oil, patience will be rewarded. From a technical perspective, the sector is showing extremely oversold conditions where positive news could ignite a rally. This bearish sentiment that currently permeates the energy sector reminds me of a quote from legendary investor Warren Buffet. Mr. Buffet earned his reputation as a savvy value investor by buying the stock of companies when they're unloved and undervalued. *"The time to get interested (in a stock) is when no one else is. You can't buy what's popular and expect to do well."* (Warren Buffet)

### DISCLOSURE:

As of Oct. 14, The Palos-Mitchell Alpha Fund holds a 14.3% weight in Canadian Oil & Gas Exploration companies.

# “The Art of investing”

Palos is an independent investment management firm with offices in Montreal and Toronto.

Our mission is to continuously earn our clients’ trust by growing, sustaining, and protecting their wealth over many generations.

We invest our clients’ money as we do our own.

Our interests are aligned with yours.

## William Mitchell, B Comm., CIM

*I am a portfolio manager at Palos Wealth Management based in Montreal, Quebec, Canada. My experience in the investment industry is extensive, having spent more than thirty years analyzing, trading and investing in global financial markets.*

*At Palos, we are driven by our values. We believe in the principles of honesty, integrity and transparency. We subscribe to a strong work ethic and we have a passion for investing. The pursuit of excellence is our motivating force. We take our fiduciary duty to heart and we always act in the best interests of our clients.*

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*If you have any questions about investing, our services, or becoming a client of Palos Wealth Management, please contact me at:*

**William Mitchell** | Portfolio Manager

**Palos Wealth Management Inc.** 1 Place Ville-Marie, Suite 1670, Montreal, QC Canada H3B 2B6

(514) 307-0575

[wmitchell@palos.ca](mailto:wmitchell@palos.ca)

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