PALOS
INVESTMENT FUNDS

May 10, 2013

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

The Need for Infrastructure

Palos continues to see energy infrastructure as a good investment. The Palos funds hold positions in Keyera Corp (TSX: KEY), Enbridge Inc (TSX: ENB), Pembina Pipeline Corp (TSX: PPL), Gibson Energy Inc (TSX: GEI), and AltaGas Ltd (TSX: ALA), all of which reported outstanding results for 2013 first quarter.

Since 2011 the Palos funds have been accumulating energy infrastructure companies. Palos had a long term view that North American oil & gas production would be on the rise, and more specifically the trend would be in heavy oil and liquid rich gas. It was clear that natural gas exploration and production capex projects would be spent on liquid rich gas plays such as the Duvernay, as the economics of drilling dry gas are next to impossible. Furthermore, the real and sustainable growth of oil is coming from bitumen. As heavy oil production rises, the need for condensate, which comes from natural gas liquids (NGL), increases as it is an essential ingredient for reducing the viscosity of that oil. If Keystone XL is approved, the need for condensate will be more in demand that it is already. As a result, KEY, PPL, and ALA will all benefit.

We are seeing some of this infrastructure demand coming through in the first quarter of 2013.

KEY reported its Adjusted Funds From Operations/share (AFFO/shr) of $1.07 which was ahead of consensus $0.94. Furthermore, KEY announced new growth projects that will bring its growth capex to $450 million. This will ultimately benefit shareholders.

ENB reported its Earnings Per Share (EPS) of $0.62 which was ahead of the $0.52 consensus. ENB is on track to grow EPS and its dividend

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.36	9.11%
Palos Equity Income Fund - RRSP	PAL 101	$6.97	5.21%
Palos Merchant Fund L.P. (Mar 28, 2013)	PAL 500	$8.56	7.20%
Palos Majestic Commodity Fund L.P. (May 9, 2013)	PAL 600	$10.91	2.76%
S&P TSX Composite			2.30%
S&P 500			15.43%
S&P TSX Venture			-20.69%

Chart 2: Market Data*

	Value
US Government 10-Year	1.90%
Canadian Government 10-Year	1.89%
Crude Oil Spot	US $96.04
Gold Spot	US $1,436.60
US Gov't10-Year/Moody BAA Corp. Spread	199 bps
USD/CAD Exchange Rate Spot	US $0.9901

* Period ending May 10, 2013

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by 12% annually through 2016.

PPL reported its AFFO/shr of $0.61 which was ahead of the $0.54 consensus. PPL has an extensive list of NGL infrastructure project which will translate into healthy EBITDA growth for the next few years.

GEI reported its AFFO/shr of $0.69 which was ahead of the $0.50 consensus. GEI is strategically well positioned to take advantage of Keystone XL if approved as this will increase volume at its Hardisty facility.

ALA reported its AFFO/shr of $0.98 which was ahead of the $0.93 consensus. ALA also announced a 4% dividend increase.

In conclusion, Palos believes that this sector is in a long term growth phase as North America is slowly becoming less dependent on foreign energy.

■ Risks, Hedges and Opportunities

By Adam Smalley

In light of the macro discussion this week by Hubert Marleau, we are reprinting an article from early last year that discussed the politics and hand-wringing over the Keystone XL pipeline. We expected that KXL would have been approved in 2012. We were wrong. However, we still expect approval ultimately and expect that such approval could be very soon.

Reprint from the February 3, 2012 Weekly:

Pipelines

The Keystone XL pipeline would run from the Athabasca oil sands in Alberta, Canada to refineries in the US from Chicago down to the Gulf Coast. Once complete, this pipeline could supply the US with 3-4% of its oil needs. Keystone is like a dedicated, high-capacity superhighway than runs virtually non-stop from Alberta to Texas. The existing patchwork of pipelines, such as Clipper, is at or near capacity and must criss-cross the country from pipeline to storage facility to pipeline until finally reaching the refineries in the Gulf. The investment managers at Palos are very interested in tracking investment opportunities coming out of the oil sands.

Keystone is going to be a major political issue in the presidential election. As is their custom, American politicians will obfuscate the issue and use scare tactics ranging from the risks of contaminated water supplies in Nebraska to the perils of depending on the Middle East. No doubt the television ads are already in production.

The truth is that the Athabasca oil sands is possibly the largest oil deposit on earth (Alberta's official estimate is 170 billion barrels of total proven reserves making it second largest after Saudi Arabia). Countries in Asia would love to lock up this supply and companies are already pursuing a "Pacific Gateway" to get the oil to China, a sort-of "Plan B" if Keystone doesn't happen.

The energy business is a dirty one -- extraction can be filthy and it uses a lot of energy, spills threaten coastlines, oil tankers pass through unfriendly neighborhoods like the Straits of Hormuz, and it forces the US to get into business with some unsavory actors. Problem is, the US consumes 22% of the world's oil with only 4% of the world's population – a Faustian Bargain. Locking up supply from a friendly neighbor is the perfect solution and we think is the likely outcome, despite all the political bickering that we will have to endure.

But if the US passes on this opportunity, China won't. That is why we don't see a lot of risk among Canadian companies in the event Keystone is killed. Clipper (owned by Enbridge) will likely double capacity through its pipes and the oils sands producers will likely divert some of their product through the Pacific Gateway (joint venture between Enbridge and Sinopec). Keyera and Pembina will provide their oil field services to the producers regardless of who the ultimate buyer is. We like Enbridge (TSX: ENB), Keyera (TSX; KEY) and Pembina (TSX: PPL). In other words, we are bullish on the oil sands even if the US makes the wrong decision.

■ What is New on the Macro Level?

By Hubert Marleau

Needless Divisive Controversy over The Keystone XL Pipeline: Approval is Imminent

The odds favour that Obama will sign off and the State Department will approve the controversial construction of the Keystone XL Pipeline. A gradual return to normal political

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calculations is expected after four years of deliberation. Some kind of deal is probably in the making to ease the sting of approval, like a climate policy announcement on power plant regulations or renewable energy incentives like solar, hydro and wind.

Once the moderate side of the environmental movement is appeased, the approval becomes a relatively simple permit. The radical side of the environmental group has little sway in Washington. As a matter of fact, the radical position is symbolic, defensive, emotional and at times manifested civil disobedience. The movement has a hard time in getting what it wants out of Washington because "it has not been able to coalesce around a centerpiece for clear energy broadly" according to Carl Pope of the Sierra Club. It suffered through the collapse of "Cap & Trade" and failure to force the Obama Administration into a major "new international climate treaty". Keystone is too visible to stop for it would be a huge victory over "Big Oil". If the greeners manage to stop the pipeline, they could stop just about anything. It's not going to happen; the crusade against Keystone is misguided and not homogenous enough to become a defining moment. It appears that the voters of Sierra Club, Friends of the Earth, 350.ORG, NRDC and the League of Conservation are more about demands than they are about facts. It seems as if they want three things; 1) bully pulpits to expound their views to a wide audience, 2) installation of regulations to eliminate greenhouse gases and 3) to kill any pipeline projects.

Moreover, the polluters clearly outnumber the greeners. This becomes evident when one realizes that an abundance of groups representing everything from oil to religious groups, including construction workers, unions, manufacturers, retailers and shopping centers have stepped up their Washington spending and ratcheted up their lobbying effort to win Keystone approval. If you were to count on Congress to pass an environmental law against Keystone, it would not happen because the pro-pipers own the joint. The enviro opponents are not very inclined to offer trade-offs to the White House for a KXL approval. This is a big reason why Obama has been slow to formally send his decision for passage to Congress. He's dragging his feet in the hope of finding a solution to placate the opponents. Nevertheless, the Keystone hand-wringing may end soon for Obama seems to a very suggestible man.

It's been over 1500 days since the application for the Keystone XL Pipeline from Canada was submitted to the State Department. The Administration is stalling the approval of the project because it's waiting for the favorable political moment. The reason to build the $7.0B project is not about bringing jobs. Yes, it would create about 20,000 high paying jobs but they would be temporary and seasonal. What the project brings is compelling economics, energy security, foreign policy independence.

1) The economics are compelling.

a) Considering that 2.0m barrels of tar sands crude can be mined daily and a cross-border pipeline would add about $20 a barrel to the wholesale price of Canadian oil, the Keystone would bring about an extra $40 million a day or $14 billion a year. This is a lot of money that can be spread around to feed opposers, investors and governments.

b) The numbers about organic reserve replacement ratio (RRR) are not assuring. In this regard, Canadian bitumen becomes very interesting. The Oil Majors have been through a phase of under-investment in exploration. Final investment decisions (FDIs) that bring oil projects into production have been conservative for oil is hard to find and discovery to production can take up to 15 years. Studies of Wood McKenzie show that a two percent production growth requires a RRR of 120% to maintain reserves. In the last 10 years, 2009 was the only year when the RRR of the Major Oils reached 120%.

c) In 2012, as much as $23 billion was sunk into the Canadian tar sands. China's state owned companies poured an estimated $30 billion on Canadian energy assets. China is confused as to why a decision to build a pipeline has not been made. Alberta has land locked oil reserves in the form of bitumen that must find a way to ocean water and, in turn, refineries to catch the economic benefits. There are few options, US, Eastern Canada, Western Canada and Northern Canada.

d) The tar sands may have high fixed costs, but will not deplete as fast as even the best conventional oil fields. Keystone is appealing for it would open the way for future production to piggyback along the same path.

2) Energy Independence comes with great benefit for international relations and policies.

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a) The US would face less demand on its military, if export dependence was strictly based on western hemisphere exporters. Strong bilateral relations, good energy collaboration, robust commercial ties and investment opportunities between Canada and the US already exist.

b) It's surely in the interest of the US not to secure its oil source from chaotic and unstable petro-regions. It would provide the US with more military freedom. The US could either withdraw from the petro-regions in favour of throwing its military weight to Asia where it's needed.

c) China is eager to diversify its energy portfolio by sourcing different crude blends from Canada. It is hard to understand why the US would let all of that Northern reserves fall into the hands of the Chinese.

3) The environmental impact is intact or nil.

a) The State Department concluded that the oil sands producers would find other markets without the Keystone pipeline.

b) The State Department concluded no matter what the specifics, the KXL project would not contribute to oil sand expansion or greater emissions of greenhouse gases.

c) Alberta oil would displace sources of heavy oil from Venezuela which produce higher volumes of gas emission.

d) A recent Cambridge Energy Research Associates study found that gasoline refined from the tar sands crude sold to the US is actually cleaner than what is refined from either Venezuelan Petrozuata oil or California Kern River Oil.

e) Gas emissions come from burning the fuel not from the transportation.

f) Improved extraction methods in tar sands have lowered emissions by 26% since 1990 and are continuing to clean up the process.

g) The Keystone pipeline would have 57 more safety features than in the hundreds of thousands of miles of pipelines already crisscrossing the US.

In conclusion, like it or not, it is our opinion that Keystone XL will be built. In one way or another, Canadian oil with eventually reach the US Gulf Coast -- by truck, rail, ship, barge or pipe. The Canadian government will have to deal with the European Union's determination that the Tar Sands are a menace to mankind. Question begets if the EU is interfering with what is Canadian jurisdiction and overstepping its role with suggestions as to what should be Canadian climate rules.

■ An Article Recommended by Hubert Marleau

An article recommended by Hubert Marleau:

"Canada as an Emerging Energy Superproducer" by Gerry Angevine and Kenneth P. Green. Published in the Frasier Institute's *Studies in Energy Policy*, March 2013.

To read this article, please click on the link below:
http://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/canada-as-an-emerging-energy-superproducer.pdf

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palosmanagement.com

Chart 3: Palos International Fund (Total Returns) **

	Last	YTD Returns
Palos International Equity Income Fund PLC - CAD	CA $5.18	4.28%
Palos International Equity Income Fund PLC - EUR	EUR 6.91	3.69%
Palos International Equity Income Fund PLC - USD	US $6.58	2.57%
S&P TSX Composite - CAD		1.26%
S&P TSX Composite - USD		0.24%

** Period ending May 7, 2013