WHEN SAFETY HURTS.

March 11th, 2022

I have typically stayed away from commodity investing. It is difficult to make any sense of how these companies plan for the future when they are the ultimate price takers. Obviously, the companies themselves find it difficult to plan according to the write downs they take at the end of every commodity cycle.

The problem with their industry is best reflected by the apparent business model of high dividend paying energy companies. The model goes something like this.

1. Raise capital
2. Drill some holes.
3. Extract the oil
4. Sell the oil to the market
5. Pay out dividends
6. Repeat

How do you build lasting shareholder value by depleting your assets and paying unsustainable dividends?

The energy company has no control over how much oil they find, how long it takes to find the oil and most importantly what sales price they will eventually achieve in the future.

Mining companies are hardly any different. They too have long lead time commodity projects similar to the energy sector but are exposed to higher “geo-political” risks. Their projects can be located in global backwaters run by despots who have a taste for expensive bribes and the fruit of nationalized resource assets.

The closest I ever came to buying a mining company was in 2019 after the Barrick- Randgold merger. I read that Barrick was planning a seismic shift in their thinking. Instead of striving to become the largest gold miner they were going to focus on profitability. Imagine that!

Even still, I couldn’t bring myself to do it. It is just too difficult of a business.

We have mentioned before that our process for determining the value of companies is to project the earnings a company will make five years in the future. We then estimate how much investors should be willing to pay for these future earnings and discount the value back to today at a rate that will allow us to earn at least 15% annually.

This is impossible with commodity companies due to the volatility in the commodity price. The estimates of earnings wouldn’t be worth the pixels they are typed with.

We have not seen the excessive capital investments that have plagued previous oil booms in the current cycle but our avoidance of commodities has saved us in the past and helps us sleep at night. We largely avoided the carnage that occurred in 2020 as it appears the Saudi's tried to flood its competitors out of the market in a sea of cheap oil. We also avoided the oil price crash of 2018.

I was very tempted to buy Peyto Exploration & Development Corporation in November of 2020 when the shares were hovering around $3 per share. Peyto Exploration is a low cost producer of natural gas where cost containment appears to be a badge of honour worn throughout the company. In the commodity world cost is the only advantage to pursue.

At the time I made a conscious decision to not make the investment for this portfolio due to the volatility and additional ESG risks it would add to the portfolio.

Since then and particularly in the last six months the roles have flipped. Commodities are hot. Risky is now safe. Up is the new down. No sustainable margins = gains. Strong competitive advantages, no thank you! The only safe havens are materials and energy. Even boring old bonds have lost value!

S&P/TSX Composite Sectors	YTD 2/28/2022
Energy	20.33%
Material	9.03%
Communications Services	3.71%
Financials	2.87%
Utilities	-1.78%
Industrials	-3.97%
Consumer Staples	-4.33%
Consumer Discretionary	-6.06%
Real Estate	-6.59%
Health Care	-11.52%
Information Technology	-34.70%

Sectors where competitive advantages have long prevailed such as consumer staples, consumer discretionary and information technology have all fallen out of favour and lost value.

These are the distortions that higher inflation, raising interest rates and war have on the markets.

Peyto Exploration's shares grew to $10.68 as of the end of February a capital gain of 256%. The company has also paid out $0.21 per share in dividends over this time. It appears that Peyto has settled into a schedule of paying out $0.05 per month or $0.60 annually. This works out to an additional 20% annual return in dividends alone based on the $3 purchase price.

Admittedly, I would have had to trim the position size to keep the position from getting too large in the portfolio.

Worst of all, buying the position would have reduced not increased the volatility in the portfolio. With energy and materials being nearly the only sectors thriving in 2022, the addition of this position would have actually reduced the volatility in the portfolio.

It is easy to see these errors when looking in the rear view mirror. I only wish that we weren't hurt so badly by the safety belt.

There is no telling how long these current market conditions will last. One thing is certain though. Eventually sustainable competitive advantages and the higher margins they bring will once again build lasting value for investors.

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Peyto Exploration and Development Corp, 2g

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