Focus on Energy

We are continually discussing global energy production and consumption issues in our newsletters because these issues are crucial to the future of the global economy, and they have enormous investment implications. Once again we will provide analysis on these issues, this time in relation to recent disruptive global events, namely the conflicts in North Africa and the Middle East, and the earthquake and tsunami in Japan. Also in this edition, we discuss the changes to the Total Return Portfolio holdings that we made during the first quarter of 2011 (Q1).

North Africa and the Middle East

Recent conflicts in North Africa and the Middle East have contributed to a rise in oil prices. With our heavy weighting in high quality, large capitalization Canadian energy companies, the performance of the Total Return Portfolio has benefited in Q1. Several nations experiencing demonstrations and conflicts are oil producers, raising concerns about oil supply disruptions. As shown in the one year chart below, West Texas Intermediate crude (a North American benchmark) has risen to approximately US$108.

(Source: www.oil-price.net)

We are not becoming complacent and assuming that the upwards trend will persist. Geopolitical events are often unpredictable, and the reduction of tensions in the region could cause oil to retreat by up to US$20 per barrel. It appears to us that the oil price is too high relative to the moderate strength of the global economy as the moment and is trading with a US$10 to $20 “conflict risk premium” imbedded in its price.

Our actions in response to these circumstances have been minimal and also carefully considered, as we remain long-term bullish on oil investments. (See our March 2011 Special Edition on peak oil theory for further details). We recently (in early Q2) trimmed our position in Canadian Oil Sands Ltd. slightly from 5.68% of the Total Return Portfolio to 4%. Our selling price was $32.74, close to the yearly high. To put this decision in context, we had added to the position in Fall 2010 at $24.97. Despite this incremental change, our sector allocation to Energy remains close to our 25% maximum sector weighting.

The various political upheavals in North Africa and the Middle East are still developing at the time we are writing this edition. We are monitoring those situations, but frankly, we have no special insights that enable us to reliably predict the outcomes. If serious internal conflicts were to develop in the larger oil producing nations in the region, a further spike in oil prices would likely occur. Due to the current conflict risk premium on oil prices, we expect volatility in the oil sector to be high in the coming months.

Tragedy in Japan

Sadly, the March 11 earthquake and tsunami in Japan took a massive human toll on those living in the affected areas. The disaster also seriously damaged the nuclear reactors and containment buildings at the Fukushima Nuclear Power Plant. As we are writing this edition, the resolution of the Fukushima Plant crisis from a containment perspective remains unclear.

From an investment perspective, the planned global expansion of nuclear power production is now far more uncertain. The crisis at the Fukushima Plant directly impacted two positions in the Total Return Portfolio, which have a combined weighting of approximately 4.6%. Exelon Corp. (a 2.4% position) is an electric utility that is the largest producer of nuclear power in the United States. Uranium Participation Corp. (a 2.25% position) is a direct bet on uranium prices, as it is an investment holding company that invests substantially all of its assets in uranium.

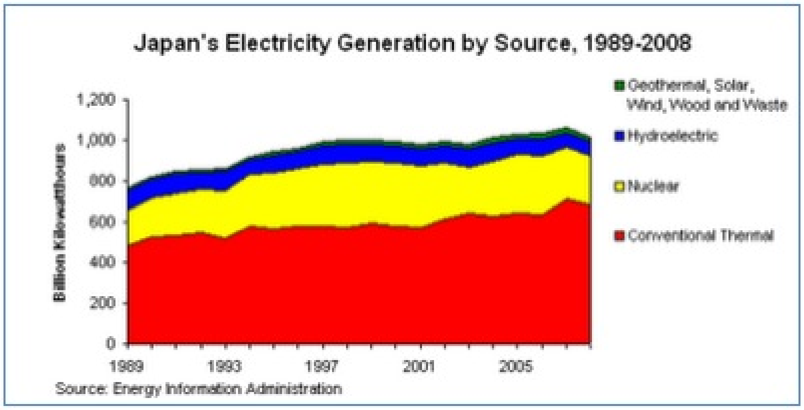
Exelon has dropped only slightly from around US$43 to US$41. For Exelon, as suggested by the minimal market reaction, the Fukushima Plant crisis does not change the fundamentals. We originally purchased Exelon based on its low valuation, high dividend yield (roughly 5% today), and stable business in anticipation of an eventual recovery in U.S. electricity demand. We are maintaining this thesis.

In the long-term, Exelon's ability to grow its nuclear fleet or pursue expansion projects at its existing nuclear plants could be somewhat affected. That said, building additional nuclear plants in the U.S. prior to the Fukushima Plant crisis was already a heavily regulated and controversial undertaking. Exelon could also face some additional costs relating to safety reviews. On the other hand, lower uranium prices could be a small benefit to Exelon in the near term. Interestingly, in mid-2010, Exelon bought wind power company John Deere Renewables for US$900 million, indicating that the company does not necessarily need to expand its nuclear fleet to grow its business.

Uranium Participation has fallen substantially (from $9 to just under $7), tracking the decline in uranium prices. We originally purchased the position at $7.29 in November, 2010. We do not currently plan to sell the position. We are going to carefully monitor the global reaction to the crisis and assess new information as it emerges. We originally purchased the position due to a recovering uranium price combined with the global demand for additional non-fossil fuel based electricity production.

Even if governments around the world want to substitute other sources of electrical power for nuclear power, they will be hard-pressed to do so while keeping electricity prices affordable for their people. Also, the decision to substitute will be complicated by the fact that all methods of electricity generation have risks and environmental impacts.

The blend of electrical generation sources in Japan itself exemplifies these issues. As shown in the chart below, approximately 25% of Japan's electricity is coming from nuclear generation.[1] If Japan wanted to move away from nuclear power, it would arguably need to increase its already substantial fossil fuel imports, as it has no significant domestic fossil fuel resources. This would be a difficult decision, as it could weaken the country economically and reduce the diversification of its power generation inputs.



So far, several countries have taken action in response to the Fukushima Plant crisis. Germany announced it will take seven aging reactors offline. Switzerland is putting three new plants on hold. China is suspending the approval process for new nuclear plants while it reviews safety standards. Chile is doing the same.[2]

Despite these announcements, we think long-term global growth in nuclear power (and therefore uranium demand) is still likely, given the lack of obvious alternatives. However, our views on Uranium Participation as an investment will remain sensitive to new information, including the full impacts of the Fukushima Plant crisis.

Total Return Portfolio - New Positions

We added a new position in Aecon Group Inc., one of Canada's largest publicly-traded construction and infrastructure development companies. Its service offering includes design and construction, financing, operating, procurement and project management. Aecon's shares are currently trading at approximately 9 times 2011 earnings per share estimates, and they pay a dividend of approximately 2%.

The main reason for our decision was undervaluation. As shown in the six month chart below, Aecon's shares fell to depressed levels in February after the company announced it would incur operating losses of $56 – 59 million on an oil sands plant project for Suncor Energy. We bought after the sell off, paying $8.78 per share. Our understanding is that the Suncor project losses are confined to the company's 2010 results

[1] Dian L. Chu, *Japan Earthquake: Impact on Crude Oil, Fuel and Nuclear Power*, http://www.istockanalyst.com/article/viewarticlepaged/articleid/4964788/pageid/1 (April 3, 2011).

[2] The Citizen, *Countries Assess Safety of Nuclear Power Plants*, http://thecitizen.co.tz/business/-/9283-countries-assess-safety-of-nucleur-power-plants (April 3, 2011).

and will not impact future earnings. Aecon has good business opportunities in public infrastructure and Alberta's oil sands. It now makes up approximately 3% of the Total Return Portfolio.

We also added a new position in Diana Shipping Inc., which focuses on transporting dry bulk commodities like iron ore, coal, and grain. This is a contrarian bet, as the dry bulk shipping industry is currently struggling with low rates, and investor sentiment towards the industry is negative. Part of the problem is an oversupply of ships, which will take time for the industry to resolve through scrapping old vessels and delaying the delivery of some new ones.

Buying a company in a cyclical industry when times are tough often results in strong gains when the cycle turns, but it is important to buy high-quality companies. We think Diana is the most attractive company in the dry-bulk shipping sub sector, as it has a young fleet of ships, no net debt and high profit margins. It also has nearly 90% of its ships on time charters (longer-term higher-priced contracts with customers) for the duration of 2011, which mitigates the effects of the depressed current spot rates. Diana now makes up approximately 3% of the Total Return Portfolio.

We also bought a small position in Frontline Ltd., a large crude oil shipping company. Current oil tanker day rates are near 8 year lows and are causing tanker companies to run at a loss. Frontline is one of the largest and strongest companies in the industry. We think Frontline represents another contrarian investment in a high quality company in an industry experiencing a cyclical low. The main risk to this investment is that an oversupply of ships continues to depress tanker rates, but Frontline will fare better than smaller competitors in this scenario and may emerge stronger. Frontline currently pays a dividend of approximately 1.5%, but the dividend is sensitive to tanker rates and could rise substantially in coming years if rates improve. Frontline now represents approximately 1.7% of the Total Return Portfolio.

We also added to our position in Great-West Lifeco Inc. slightly after a short-term decline in the stock price. Great-West makes up approximately 3.6% of the Total Return Portfolio after our incremental addition.

Finally, we bought a new position in National Grid PLC. National Grid is a large utility that owns the high-voltage electricity transmission network in England and Wales and operates the system in those regions as well as Scotland. It also owns and operates the high pressure gas transmission system in Britain. In the U.S., National Grid own electricity transmission assets as well as gas distribution assets in the Northeast. National

Grid now makes up approximately 2.5% of the Total Return Portfolio. It pays a dividend of approximately 6%.

Conclusion

While we are not overly bullish on the market as a whole, we did find some opportunities to deploy cash in Q1 of 2011 in some attractively valued securities. Our cash equivalents position in the Total Return Portfolio continues to exceed 20%, so we remain conservatively positioned.

With all of the high profile news events in Q1, we did not even find space in this edition to discuss the 30 year high in silver prices and the all-time high in gold prices established during the quarter. We continue to view our precious metals holdings positively and we made no changes to those holdings during Q1.

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