

# Oil and gas update

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## OIL

### Supply and demand

- Oil discoveries have dropped significantly since 1930.
- Oil is now being found in frontiers – deep water, the Arctic or non-conventional sources such as heavy oil and oil shales.
- These barrels are a lot more expensive than the oil we are used to getting from the Middle East and North Africa because of higher production costs.
- The world is very much focused on US demand for oil.
- Even though the US is the biggest consumer of oil, the incremental barrel is going to be consumed in emerging markets.
- We believe any drop in oil demand from slowing European and American economies will be picked up by energy-hungry emerging markets whose residents are buying cars with new-found wealth.
- In developed markets, oil demand increased by 200,000 barrels a day in the first quarter (Q1) of this year, compared to Q1 of 2010.
- Despite higher prices, consumption was up 2 million barrels in emerging markets over the same period.

### Production

- We think the civil war in Libya will last the rest of the year since NATO and the rebels have failed to oust Gaddafi.
- Spare capacity runs at about 4.5 million barrels a day if Libya produces its full 1.6 million barrels.

- Libya currently has 1.3 to 1.5 million barrels offline, so the effective spare capacity is just over 3 million barrels a day.
- Over 80% of the spare capacity lies in Saudi Arabia alone.
- Production in Saudi has been rising to just under 9 million barrels a day.
- The peak in Saudi oil production was at 9.7 million barrels in the summer of 2008.
- The official production capacity for Saudi is 12.5 million barrels per day but we don't think it can produce more than 10 million.
- Even if the Saudis can actually produce 12.5 million barrels a day, and Libya can produce 1.6 million barrels a day, then spare capacity in 2012 would still drop below levels seen in 2005 to 2006.
- Real spare capacity could be less than 1 million barrels, so the market is tight.

### Costs and pricing

- From 2002 to 2008, production costs were up 50% to 100%.
- We're still seeing cost inflation, especially in the oil sands.
- Currently, we believe the world cannot handle \$150 oil.
- The US consumer is starting to suffer at \$4.20 a gallon for gasoline, or the equivalent of about \$115 for oil.
- US household incomes have been largely flat since 2001, yet the cost of food and gasoline has doubled during that time.

- This year, we think West Texas Intermediate (WTI) will be capped at \$115 per barrel.
- Before the Libyan civil war, WTI was trading at about \$85 per barrel.
- Our downside target is approximately \$90 per barrel since over a million barrels of light, sweet crude have been taken off the market.
- Once the market realizes how tight supply is, oil prices could spike to \$150 per barrel in 2012 to 2013.

## GAS

### Supply and demand

- The International Energy Agency expects a significant increase in gas demand, particularly from China and the Middle East.
- Canada doesn't currently participate in the global gas market, but we're getting there.
- One to three liquefied natural gas (LNG) terminals are expected to be built on the west coast of Canada.
- Our biggest concern is the increase in supply. This growth is slowing with less drilling to hold land and companies reallocating capital to "oilier" plays.
- Gas is the only commodity that has not been repriced by China.
- We expect Nymex gas prices to approach world prices when we start exporting gas from North America in four to five years.
- Long term, we are bullish on gas prices.

### Costs and pricing

- Oil and gas are far cheaper than alternative forms of energy.
- Gas companies such as Encana and Chesapeake are chasing growth at any price just to retain land.
- As companies have chased production growth, returns have declined.
- Fossil fuels still generate 90% of our energy needs and none of the renewables has the scale or cost structure to be competitive.

- Because of increasing costs, it can be difficult to make money in energy.

## SENTRY ENERGY GROWTH AND INCOME FUND

- We're a specialist energy management team, travelling to oil fields around the world to conduct our due diligence.
- We're index agnostic, meaning that we don't try to replicate index-like strategies.
- We focus on opportunities, not the index, so exposure to index volatility is limited.

### Our approach

- We look at the internal growth of the business, the soundness of its balance sheet and the cash flow it delivers, especially in a flat commodity price environment.
- We look deeper at wealth creation, asset quality, risk management and our assessment of the total return potential of the investment.
- Wealth creation yield stems from the cash flow generated in excess of the amount of capital an oil and gas company requires to sustain its business and overcome base declines.
- We look at risk related to geology and the operating jurisdiction, since many international jurisdictions will warrant a much higher risk premium.
- Our capability allows us to analyze the geology and technical aspects of a producer's assets, as well as to comb through the footnotes of financial statements.
- We avoid what we call in our example company "Chronic Capital Destroyer" – a real company with the name changed that doesn't pay a dividend and is very highly leveraged to natural gas, which accounts for over 80% of its production.
- "Chronic Capital Destroyer" has typically been a serial issuer of equity and convertible debentures to fund its own unprofitable capital expenditures.

- Unlucky investors in “Chronic Capital Destroyer” have been rewarded with declining per share metrics and successive dilutive financings.
- In general, the highest-quality stocks that exhibit the highest return potential end up in our portfolio.

### Holdings

- The Fund generally aims to be about 75% invested in income-oriented energy securities like dividend-paying oil and gas producers.
- Weightings are determined by our view of broad equity markets as well as the relative return expectation for the various subsets in the energy universe.
- Our general expectation is that the three quarters or so of the portfolio that is income oriented will have a minimum expected return of 10% to 15%.
- One quarter of the portfolio augments this “anchor” and is populated by the very best capital appreciation “opportunities,” where we expect a return of 25% or more.
- This forms our mandate of income and growth, with a singular, disciplined approach to stock selection.

### Performance

- The Fund provides superior risk-adjusted returns and positive, after-tax income.
- The Fund’s yield as at May 31st was 5.7%.

- That yield is over twice that of the Energy ETF at just 2.3%.
- Over a two-year period ending May 31st, the Fund has outperformed the S&P TSX Capped Energy Index by 51%.
- Since its inception (March 16, 2009), the Fund has captured substantially all of the upside of the Index during months when the Index was up.
- More importantly, the Fund has typically generated positive returns during months when the Index was down.
- Only one other fund in the peer group (a universe of 20 mutual funds) provides a regular monthly distribution.
- Sentry Energy Growth and Income Fund has outperformed that fund by 21% since inception.

### Sentry Energy Growth and Income Fund

#### AVERAGE ANNUAL COMPOUND RETURNS (SERIES A)

1 YEAR	2 YEAR	3 YEAR	S.I.
38.2%	34.1%	n/a	44.5%

As at May 31, 2011

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. The indicated rates of return are the historical annual compound total returns net of fees (except for figures of one year or less, which are simple total returns) including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

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Sentry Investments