SUMMER 2012

INVESTMENT OUTLOOK

Natural Gas: Opportunity or Value Trap?

THE GLOBE AND MAIL
Natural Gas Futures Hit Another 10-Year Low
March 28, 2012

NATIONAL POST
Natural Gas Glut Threatens Price Collapse
March 30, 2012

The Dallas Morning News
Natural Gas Glut Means Drilling Must Slow, Experts Say
April 8, 2012

THE GLOBE AND MAIL
Natural Gas Glut Seeps Into High-Price Markets
April 12, 2012

THE WALL STREET JOURNAL.
Exxon: 'Losing Our Shirts' on Natural Gas
June 27, 2012

The North American natural gas market has undergone significant changes to its supply and demand fundamentals over the past few years. The introduction of technological innovations, like horizontal drilling and multi-stage hydraulic-fracturing, has made previously uneconomic natural gas reservoirs more accessible and highly productive. These new developments have brought about an increase in supply which has been positive for consumers due to the decline in natural gas prices but extremely challenging for natural gas producers.

Over the past three years, natural gas production has increased by 19%, while consumption has only risen by 7%. Furthermore, the U.S. experienced its fourth warmest winter since record-keeping began more than a century ago. Although parts of Western Canada seemed to endure harsher than usual temperatures, our friends to the south enjoyed a very mild winter. The result? A 67% collapse in natural gas prices down to levels not seen since 1999.

"Given our long-term approach to investing, we have the ability to withstand, and more importantly, benefit from large and prolonged fluctuations in prices."

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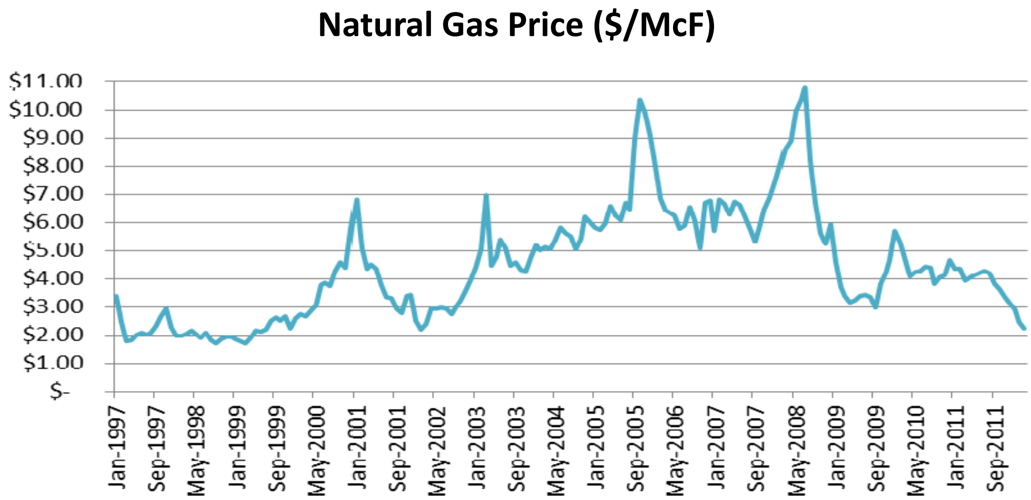
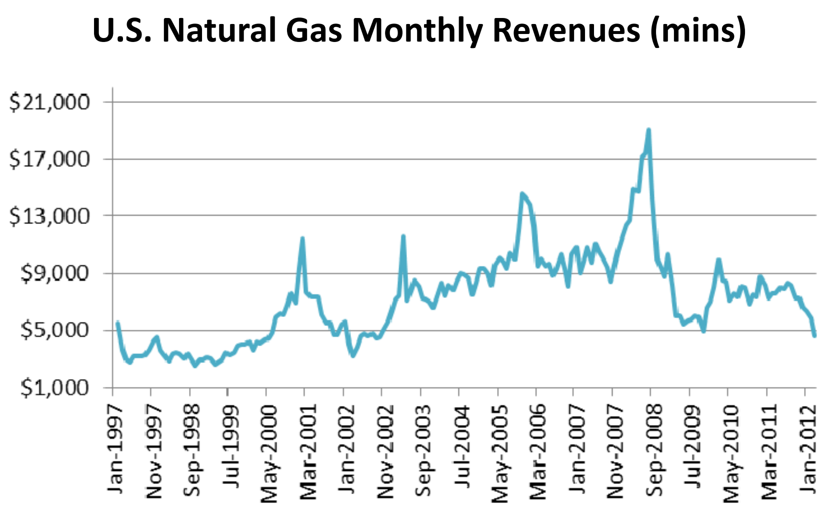
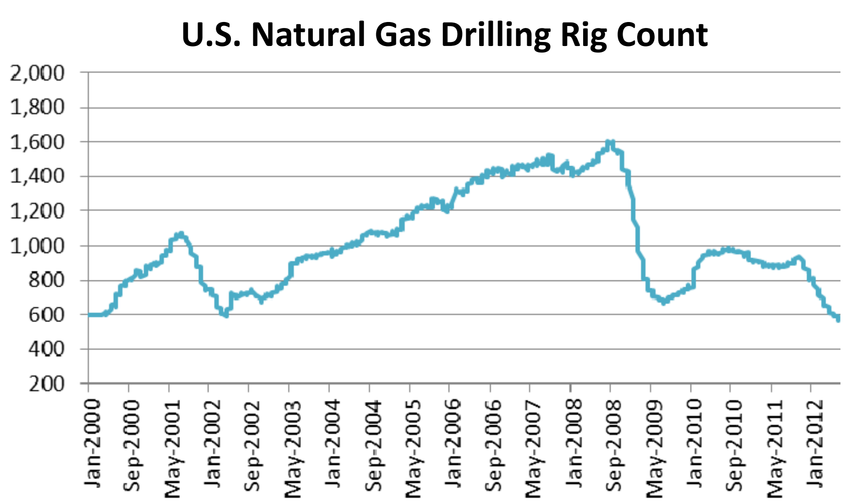


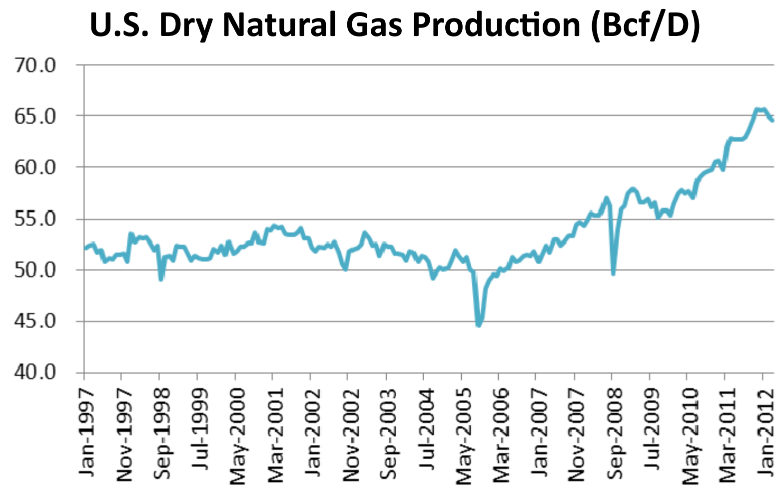
To earn a positive return on invested capital, natural gas producers on average need a price above $4.50 per thousand cubic feet (mcf). With natural gas prices at $2.50 per mcf, producers are a long way from earning an economic return.



As a result, natural gas producers are taking drastic steps to improve margins. They are shifting capital from lower return natural gas drilling to higher return oil projects. This has resulted in a 40% decline in the natural gas drilling rig count since October 2011.



In addition to reducing natural gas drilling, producers are shutting-in higher cost production. In the first quarter of 2012, natural gas companies such as EnCana, ConocoPhillips, Chesapeake, and Progress Energy announced total production shut-ins amounting to over 1 billion cubic feet a day (bcf/d), or approximately 1% of daily production. As you can see from the charts below, these efforts are starting to impact production.



While producers do their best to navigate the low natural gas price environment, the demand-side of the equation is starting to improve for them. Consumers are increasing their demand for natural gas in the following ways:

1. Power utilities are increasingly using natural gas as a substitute for coal.
    - Natural gas consumption in power generation was up 41% year-over-year in March and up nearly 32% year-over-year in the first quarter of 2012.
2. Industrial and petrochemical companies are making significant investments in new projects due to the lower input costs (natural gas) in North America as compared to Asia and Europe.
    - Dow Chemical, Sasol, Lyondell-Basell, Shell, and Methanex have announced multi- billion dollar projects in Louisiana and Texas.
3. Natural gas exports via Liquefied Natural Gas (LNG) are on the horizon.
    - Cheniere Energy, Shell, and EnCana have announced large-scale LNG projects. Cheniere's facility will be located in the Gulf of Mexico while EnCana and Shell are looking to build plants in Kitimat, BC. The earliest we expect to see natural gas exports is 2015.

So what does all this change mean? Although current conditions appear gloomy for natural gas producers, valuations for natural gas assets have fallen to a point where they are starting to attract shrewd long term investors. Private equity firms, such as Blackstone, Apollo Group, and KKR, have made large investments in natural gas assets over the past six months. Furthermore, owners of natural gas power plants around the globe are making significant investments in natural gas assets. For example, Toyota Tsusho and NW Natural have partnered with and purchased assets from EnCana to gain access to natural gas production in order to offset the cost of purchasing gas in the open market. Finally, we continue to see long-term commitments to natural gas via mergers and acquisitions as PETRONAS, the Malaysian national oil company, recently made an all-cash bid for Canadian natural gas company Progress Energy, held in Leith Wheeler clients' portfolios, at a 75% premium to where the market was valuing Progress.

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We, too, are positive on the long term prospects for natural gas. We have added recently to our natural gas investments (EnCana, Progress Energy, Tourmaline and NuVista Energy). Our investment thesis is based on our view that natural gas prices of $2.50/mcf are not sustainable. Our work and conversations with experienced oil and gas management teams tells us that the full cycle economics of acquiring, exploring, producing and developing natural gas assets are not profitable at these prices. We believe the marginal cost to produce natural gas is closer to $4.50/mcf and that the long term price of the commodity will revert to that level. We are also confident that the companies we own are amongst the lowest cost producers of natural gas in North America and, as such, will profit richly when natural gas prices revert to the marginal cost of production. Furthermore, as more LNG facilities are added to export North American natural gas, the price will move in the direction of LNG pricing, seen today at $15/mcf.

Given our long-term approach to investing, we have the ability to withstand, and more importantly, benefit from large and prolonged fluctuations in prices. We believe the natural gas companies we own can endure low natural gas prices and will benefit from a rising price environment. We remain patient with our natural gas holdings and expect them to outperform as natural gas prices return to more sustainable levels over the long run.

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