

QUARTERLY INVESTMENT OUTLOOK



Third Quarter 2004

*We asked our clients
what they wanted to
see...*

*...and are back in
production.*

After a brief hiatus, our Investment Outlook is back. We will be drawing on a wider range of resources in our firm to present our view of issues that we feel are of importance to our clients. We hope that you enjoy.

Oil and Gas Income Trusts...Value or Ponzi Scheme?

We recently spent a week in Calgary looking for ideas at investor conferences for oil and gas companies and oil service stocks. We found slim pickings. Portfolio managers jammed the presentations of the smallest companies, a reversal of the usual pattern of interest in only the big companies. Most of the junior companies' stocks have been bid to the stratosphere and many are selling at more than twice their asset value. It's understandable that oil stocks have done well. Oil prices are at levels only dreamed of a few years ago. For oil service companies, the all time high level of well drilling means that business is strong. But oil prices and drilling activity is cyclical and for every peak there is a valley. Many of the seasoned portfolio managers commented that the valuations of the junior oil companies were unsustainable. A common theme was "sure they are pricey, but you can't be out of them if they are moving". That sounds to us like the same rationale that led to the tech blow up. Apart from high oil prices and the abundance of investment dollars looking for a home, another factor that has driven junior oil stocks higher is the emergence of oil and gas income trusts. While oil and gas trusts have been around for many years, their numbers have exploded recently.

Trusts usually pay out all their cash income to avoid paying income tax (the unit holders pay the tax). Unit holders like the distributions...some even think of the distributions as "yield". Of course, it isn't yield because oil well production declines each year. Typical decline rates are in the order of 25% for most trusts. If production declines and oil prices don't go up, the cash flow paid to investors also declines. Soon, there would be no payout and no yield. What many investors in oil and gas income trusts view as "yield" is better described as "a return of some of your capital".

How does the proliferation of trusts affect the market value of oil and gas stocks? The answer is that trusts have commanded a higher valuation than oil and gas stocks and they have used that valuation to make acquisitions. When any trust pays out all its available cash, it has none left to grow the company. In the case of oil and gas trusts, there is no cash available to explore or buy new reserves to overcome production declines. This leaves only one strategy available to maintain distributions: issue new units to new investors for cash and use the cash to buy new production. So far this has worked because the valuation applied to oil and gas trusts has been so much higher than the valuation applied to oil stocks or oil reserves. In other words, when the trust sold a new unit, they may have given up a proportional interest in half a barrel of reserves that they already own, but they took that cash and bought a full barrel of new reserves because the new reserves were relatively cheap. Good work if you can get it. Ponzi invented it.

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So, with the huge appetite for new reserves, and what has been a big difference between trust valuations compared to the cheaper oil companies, income trusts have been snapping up reserves and oil companies. Many oil companies have sold out to income trusts or converted themselves into unit trusts, their shareholders enjoying big paydays along the way. As a result, there are only a handful of intermediate sized companies left. The junior companies now tell their shareholders that they will only be in business for a couple of years and will then sell out at a high price to an income trust. Not surprisingly, the junior companies are being priced as though they are income trusts today.

Shareholders are not the only winners in all this. Managements of the acquired companies are enjoying a bonanza. Usually, when the junior is "trusted", the same management forms a new exploration company. The new company starts with a little of the prior company's production and a lot of its exploration properties (remember the income trust has no money for exploration). The first thing the new management does is issue stock to themselves at asset value. The stock can then be expected to start trading at twice asset value making these managers all potential Leith Wheeler clients.

At some point this bonanza, where every one wins, will end. Historically, when oil stocks are at high levels the supply rises due to new stock issues, and demand falls because something else came along or the commodity price dropped. This time there is the new income trust factor at play. A blow up in the trust sector or rising interest rates, which would reduce trust valuations, introduce a new risk to oil stock valuations. As a result, we have reduced our oil exposure and have focused our investments in this area on value plays, avoiding a game to which there is an inevitable end.

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What's New?

We added a new member to our bond team this year. In January, Perry Teperson joined us after thirteen years as an actuary and investment consultant. Most recently, he led the investment consulting practice in the Vancouver office of a multinational actuarial and consulting firm. During this time he managed large accounts and provided advice on investment strategy, including the matching of bond assets with pension plan liabilities. Perry graduated from the University of Cape Town with a Bachelor of Business Science degree awarded with distinction (1990). Perry is a Fellow of the Faculty of Actuaries and Canadian Institute of Actuaries and holds the Chartered Financial Analyst designation (CFA). He is also a member of the Vancouver Society of Financial Analysts. His role at Leith Wheeler is to provide fixed income research and analysis, and assist in the management of our bond portfolios.



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