Energy

COMMENTARY Q2 2016

NORM LAMARCHE | CRAIG PORTER

FRONT STREET SPECIAL OPPORTUNITIES CLASS
FRONT STREET GROWTH FUND / FRONT STREET GROWTH CLASS
FRONT STREET RESOURCE GROWTH & INCOME CLASS

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ENERGY OVERVIEW

Just when you thought that the investing world could not get any more interesting, along came "Brexit", the U.K.'s vote to exit the European Union.

"Unusual", "unorthodox", "confusing" and "unconventional" are just a few of the words used to describe the current state of capital markets – and this by the long-time, seasoned veterans of the game. It's a capital market where approximately one-third of global government bonds are trading at negative interest rates (that's right: where the investor pays the government to own their bonds!). Will the U.S. Federal Reserve raise or lower interest rates? Will a Trump presidency lead to trade wars? It's a capital market world where bad economic news is viewed favourably for stocks (because a weak economy would lead to a prolonged environment of lower interest rates, which makes equities more attractive as alternatives). This is a world where geopolitics and security issues have an unprecedented standing in our news flows. And much of this is the price we are paying for having been bailed out by governments since the 2007- 2008 credit crisis.

Then came Brexit! The vote by the English to leave the European Union was followed by currency and stock market volatilities, as investors were left wondering not only about the state of the euro, but more importantly, on the resulting state of the EU.

While investors have been rattled by—and are trying to decipher—Brexit, it is worth noting that the energy sector has had its own Brexit-type moment. That moment was the energy shale revolution. It led to an energy environment where commodity prices collapsed by two-thirds, and an industry that experienced a record number of bankruptcies and layoffs. It has put energy nations at risk, and sent investors in banks (who lent to the energy patch) scurrying for the exits.

The energy sector is now two years into this collapse – and well on its way into recovery! We believe oil prices will continue to work their way higher, but not without volatility. Oil prices continue to trade at a level that does not attract sufficient capital spending globally (to bring new production online) to offset the naturally declining production of existing wells.

FRONT STREET SPECIAL OPPORTUNITIES CLASS

FUND MANAGER: NORM LAMARCHE

The Canadian market managed to hold onto its gains in the second quarter of 2016, thanks to the metals (+26.4%) and energy (+8.6%) sectors. Health care (-15.5%) and information technology (-6.1 %) weighed on the markets during that same period.

The Front Street Special Opportunities Class was up 28.8% for the quarter.* Contributing to the fund's performance were holdings in Arizona Star, Xtreme Drilling and Crew Energy. Weakness came from RMP Energy and Chinook Energy.

The fund continues to be invested predominately in energy. While most materials stocks have had a significant run, we continue to be challenged by the state of the world economy, particularly the emerging nations' demand for raw materials. Over the course of the second quarter, we continued to add to the fund's weightings in natural gas producers as well as the energy services group, while trimming down the "oilier" exposures.

*See chart below for specific performance information for relevant funds.

The North American natural gas market—in contrast with oil—is more of a North American-centric commodity. As such, its supply, demand and cost structures are fewer and more finite to observe. Natural gas fundamentals have been improving steadily over the past year; unfortunately masked by what was one of the warmest winters on record in 2015-16. Winters are always a big demand draw for heating purposes, and the warmer winter left end-of-season natural gas inventories at record highs, sending the commodity and natural gas shares plummeting early in the year. Canadian natural gas prices traded down to zero for a brief period during the late winter.

Hidden amongst the warm winter was steadily improving structural demand from the electrical generation side (at the expense of coal), the industrial side, as well as growing exports to Mexico. Liquefied natural gas (LNG) out of North America also made its debut early in the year and will soon become a large demand segment for North American natural gas over the next five years.

We've always referred to these North American energy shales as being the biggest arbitrage in our energy lifetimes. Natural gas is a great example, as its ample supplies and low-cost production is pushing out expensive and dirty coal, higher-cost supplies in Mexico and LNG supplies globally.

With the summer heat kicking in, record power consumption in the U.S., growing exports to Mexico and declining U.S. natural gas production have had a swift impact on North American natural gas prices – sending NYMEX natural gas prices up almost 40% in June alone. We expect prices to continue to recover into the next year.

FRONT STREET GROWTH FUND/ FRONT STREET GROWTH CLASS

FUND MANAGER: NORM LAMARCHE

The Front Street Growth Fund was up +26.3% during the second quarter.* Contributing to the fund's performance were holdings in Augusta, Crew Energy, Trinidad Drilling and Painted Pony Petroleum, while Delavaco Properties and Tidewater were detractors.

We have been adding to the fund's energy services group. It's an industry that has lagged energy producers year-to-date, but we believe that the spending rebound by North American producers is beginning now. With oil prices having recovered from the high $20s to $50 per barrel over the past three months, some of the low-cost, efficient producers with cleaner balance sheets have been ramping up their capital expenditure spending. While it's still early days, we expect those numbers to increase with a better commodity price into next year. The U.S.-based rig count has now increased for five out of the last six weeks (from exceptionally low levels).

We expect expanded drilling activities to occur initially on the better, low-cost energy shale deposits in North America. Our investment strategy in the services group is to target the companies that are exposed to these deposits with better drill rigs.

FRONT STREET RESOURCE GROWTH & INCOME CLASS

FUND MANAGER: CRAIG PORTER

At its early June meeting, OPEC nations agreed that they would make no adjustments to crude output levels, as they felt the market would eventually balance itself out. We have, indeed started to witness this, with the price of oil rising 26% over the quarter. Massive cutbacks in exploration budgets have led to a sharp drop in oil production in countries outside OPEC. Oil supply has also been hurt by political turmoil in countries such as Nigeria, Libya and Iraq, as well from the wildfires in the oil sands region of western Canada. We feel that, if we're not there, we're very close to a balanced market, and it will only tighten with rising global demand. We continue to have a positive outlook for some of the stronger, dividend-paying energy companies like Whitecap, Crescent Point and Vermilion, which have been

*See chart below for specific performance information for relevant funds.

disciplined through the downturn and protected their balance sheets.

The price of natural gas rebounded sharply in the second quarter after falling to depressed levels last winter as inventories ballooned as a result of warmer weather and reduced heating demand. However, we feel that we could be back to normal levels in the upcoming winter. During the spring and summer, we have seen a few factors conspire to drive prices higher, such as a lack of drilling over the last couple of years, which has helped to limit growth in supply. However, it's on the demand side that we see the real drivers for the recovery. Gas usage in North America has been steadily increasing as a cleaner burning alternative to coal for electricity generation. We are also seeing significant exports going to Mexico and overseas from the new liquid natural gas facilities in the Gulf of Mexico. Add in air conditioning demand from the warm start to the summer and you create a strong scenario for a recovery in natural gas pricing.

Merger and acquisition activity has started to increase with many of the larger dividend-paying energy companies picking up assets from smaller, less financially stable competitors. We are unlikely to see many dividend increases in the early stages of the recovery in oil and gas prices. Companies will be more likely to repair their balance sheets first, then apply capital to these newly acquired properties, before increasing payouts to shareholders.

We have started stepping back into the energy services sector recently. As the price of oil and gas recovers, many producing companies are issuing equity, and we are seeing some early signs of a recovery in exploration and capital spending. Upcoming second quarter earnings for many companies will be weak, likely at cyclical lows, allowing us to add to our positions on any further weakness, to take advantage of a recovery in earnings over the next year.

We have also been finding good yielding investments in the utility and pipelines sectors through companies like TransCanada, Algonquin Power, Keyera and Pembina Pipeline. These companies have strong balance sheets and growth projects that should allow them to increase dividends in the years to come.

The top performing group on the TSX this year has been the gold sector, which was up 39% just in the second quarter alone. Investors have been stockpiling the metal as a "safe haven" investment on the back of political and economic turmoil around the globe. The price of gold was up over 8% this quarter, while the price of silver rose over 20%. With over $10 trillion of government debt now trading with negative yields, investors are looking for a safe investment that will at least hold its value. We also saw demand for metals pick up in the aftermath of Britain's vote to leave the European Union. What has investors nervous is not England separating, it's the thought of other weaker members, who hold significant debt, exploring leaving and the implications for the global banking system. The outperformers in the group are not the senior metals producers, but the smaller producers and mine developers. Companies held in the fund, such as Semafo, Roxgold and Newmarket Gold, have all seen share prices more than double this year. Although we feel that the factors that started the rise of precious metals prices will remain in place the rest of the year, we will limit our exposure to the sector. Very few gold companies pay significant dividends, so we must balance the desire for growth with the need for income in this portfolio.

Another top-performing sector during the quarter was the diversified mining and metals group. While many companies rebounded sharply off very low bases this winter, we fail to see the economic impetus to sustain a rally in the sector. China, the world's largest consumer of most commodities, has been showing weakness in many of its manufacturing sectors. In addition, most base metal and bulk commodities, like coal and iron ore, remain in a surplus inventory situation. The one metal where fundamentals look excellent is zinc, where mine closures have limited the supply. We maintain exposure to this metal through Nevsun Resources, which owns a strong cash flowing mine in Africa.

Until we see further signs of global economic growth, we will maintain minimal exposure to the mining group.

The fund continues to maintain a low exposure to the forestry sector. Although Canadian producers will benefit from the lower Canadian dollar this year, the expiration of the Software Lumber Agreement with the U.S. has created much uncertainty. If a new agreement isn't concluded by the fall, we could see import duties and volume quotas that could harm the Canadian producers.

FRONT STREET GROWTH FUND

As at June 30, 2016[1]

YEAR-TO-DATE	ONE YEAR	THREE YEAR	FIVE YEAR	SINCE INCEPTION	SINCE INCEPTION
37.0%	-13.4%	-13.2%	-18.1%	7.8%	12.6%

FRONT STREET GROWTH FUND

As at June 30, 2016[1]

YEAR-TO-DATE	ONE YEAR	THREE YEAR	FIVE YEAR	SINCE INCEPTION
36.0%	-12.6%	-11.4%	-17.8%	0.1%

FRONT STREET SPECIAL OPPORTUNITIES CLASS

As at June 30, 2016[1]

YEAR-TO-DATE	ONE YEAR	THREE YEAR	FIVE YEAR	TEN YEAR	SINCE INCEPTION
38.1%	-4.4%	-5.0%	-13.2%	-0.6%	12.6%

FRONT STREET RESOURCE GROWTH & INCOME CLASS

As at June 30, 2016[1]

YEAR-TO-DATE	ONE YEAR	THREE YEAR	FIVE YEAR	SINCE INCEPTION
26.8%	-5.6%	-29.8%	-18.2%	-4.4%

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