Issue 36

PALOS
INVESTMENT FUNDS

September 7, 2017

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Palos Weekly Commentary

■ Palos Funds

By Charles Marleau

Gearing Up!!!

On September 5th 2017, Secure Energy Services Inc. (TSX:SES) announced some changes at the management level which we see as positive for the future growth of the company. Mr. Allen Gransch, formerly Chief Financial Officer of SES, will take the roll of Executive Vice President of Corporate Development. This will allow him to spend the majority of his time on acquisitions and green field projects. This change should translate into more deals and growth projects in the coming years. This is also a strategic and prudent way of grooming the future Chief Executive Officer of SES.

In addition to the management changes, the company announced a new complementary project to SES' existing business. They are going into the midstream business with a $75 million pipeline project. The project is expected to be completed in the fourth quarter of 2018 and will be 37 km long with a terminal. The project comes with 10yr commitments with producers around the area and all of them are strong and credit worthy.

SES' long-term midstream strategy is not to compete with the larger players, but rather to focus on the tie-in pipelines where they have facilities so that they can provide additional services to existing customers. We see it much more as an add-on service. Our favorite energy services name remains SES as it continues to trade at historical lows (8x EV/EBITDA) and continues to generate significant cash flow. It's only a matter of time before the market realizes its value.

■ What is New on the Macro Level?

By Hubert Marleau

On the "Rule of 20":

A few weeks ago, we accepted that the potential for stock market rewards is low because there were many unknown geopolitical and domestic risks at a time when valuation of equities from an historical point of view appeared stretched. Yet, we argued that although the current bull market has been running since March of 2009 and the stock market might be fully priced, it was not

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.52	1.65%
Palos Equity Income Fund - RRSP	PAL 101	$6.26	1.33%
Palos Merchant Fund L.P. (Jun 30, 2017)	PAL 500	$4.22	5.65%
Palos WP Growth Fund - RRSP	PAL200	$10.02	0.20%
S&P TSX Composite			0.14%
S&P 500			11.67%
S&P TSX Venture			52.23%

Chart 2: Market Data*

	Value
US Government 10-Year	2.04%
Canadian Government 10-Year	1.94%
Crude Oil Spot	US $49.14
Gold Spot	US $1,350.10
US Gov't10-Year/Moody BAA Corp. Spread	217 bps
USD/CAD Exchange Rate Spot	US $0.8250

* Period ending Sep 7, 2017

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overvalued when one considers that we are in a long regime of low interest rates and inflation. While the market is always vulnerable to a 10% correction, bear markets are for most part associated with recessions. At this time, there is no serious threat of an economic contraction. Indices that gauge financial stress and recession risk are sanguine and cheerfully optimistic and all high frequency economic models are tracking better than 2.5% growth for the current quarter. I came accross an additional indication that Byron Wien, the sage Blackstone strategist, made allusion to in this week's Barron's. It's call the "Rule of 20". The rule is simply the combination of inflation and price-earnings ratios. It stipulates that for as long as the rule is not higher than 20, one would be correct to judge that the market has not being is flagrantly high. Currently, the combination is presently set at 19.3. Assuming that there is no recession in sight for the next 12 months and the annual rate of inflation stays below 2.0% as current data suggest, the earning outlook would bring the combination index to 17, if the stock market was to stay put.

On Canada: no surprise here!

The Bank of Canada decided to hike its policy rate another notch ahead of the Fed. The Canadian Central Bank jump the gun 1) publicly citing that recent economic data have been stronger than expected and more broad-based and self-sustaining, 2) internally believing that the strength of the economy was overly dependant on the heavily indebted household sector and 3) probably feeling that it was time to calm down the red hot housing sector. As a result, the Canadian dollar shot up to 82.25 us cents, about three cents above our estimated Purchasing Power Parity Rate of 79 us cents. Moreover, the unfavourable differential in interest rates between Canada and the U.S has virtually disappear. In this connection and given sluggish inflation and dependance on what is going on in the U.S., we are of the opinion that the Bank of Canada will tend to follow in the future the Fed's monetary stance. Accordingly, it makes sense to,think that the future path of the loonie will essentially be a function of the price of crude oil. It should be noted that anything above $55 for a barrel of oil could bring about economic, financial and currency effect to the upside.

On Money Management:

Investors are always subject to a medley of risks that are impossible to avoid. That is why we tend to worry about geopolitical events, interest rates, liquidity, volatility, recession among many other issues. Unfortunately, investors tend to fear these risks more than they should because they tend to mix their emotions with investing. History and scientific research show conclusively that when investors divorce emotions from investment decisions, they do far better than those that do not. A team of researchers from Carnegie Mellon University, the Stanford Graduate School of Business and the University of Iowa founded that by kinking brain science to investment behaviour people with impaired ability to experience emotions make better financial decisions than other people. This type of research is part of a fast growing interdisciplinary field called " neuroeconomics". It explores the role biology plays in economic decisions making by combining insights from cognitive neuroscience, psychology and economics. Put simply, investors who are focused, mentally tough, rational and strict usually avoid costly knee-jerk actions. In other words, emotional stress cause people to panic and/or miss out on opportunities. This is why one needs to keep his composure and take control of one's emotions. That is a difficult task to undertake. In this connection, seasoned investors use central tenets, established principle heuristics, rules, shortcuts in order to avoid emotional mistakes. By doing this, they apply a collection and diversity of models to their investment strategies and don't react emotionally to things. The method will not uncover universal and general-purpose models; but, in this way, investors are better able to act in their own self-interest when they make economic and financial decisions. In simple language, an attentive and well informed investor would check and review a variety economic rules before making any decisions that involves future prices, future profits and future interest rates. In an environment of unknowns, vigilance allows a watchful investors to turn ongoing events, printed data and statistical observations into partial maps that can hopefully illuminate the investment terrain and concurrently help to make better judgement or calculate rational expectations. The investment world is complicated and filled with a host of uncertainties, and in turn, it's wiser to use rules than make outright guesses. At least, in this way there is a real effort to try to get it right.