FOYSTON, GORDON & PAYNE INC.

INVESTMENT COUNSEL

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Assessing the Risk of Stranded Carbon Assets

In early June, G7 leaders committed their countries to reducing carbon emissions by 2050 and eliminating them by 2100. Even before the G7 announcement in Germany, there had been concerns expressed over how carbon reductions might impact investors in energy and energy-related companies. If governments legislate reductions in global carbon emissions, the fear is that oil, gas and coal consumption would decline, resulting in capitalized fossil fuel reserves that will never be extracted. These potential surpluses are referred to as *Stranded Carbon Assets*.

This document outlines the manner in which Foyston, Gordon & Payne (FGP) thinks about the risk of stranded carbon assets and how we factor this risk into our investment analysis of companies in the energy sector.

Time horizon

For most institutional investors, the timing and implementation of government legislation may surpass investment time horizons. While the liability streams of pension and endowment funds can be long - with benefit obligations for active pension plans stretching out more than 50 years - the investment time horizon for asset mix assessment is considerably shorter – normally five to 10 years. Furthermore, while the definition of "stranded asset" is open to interpretation, regulatory changes will be incremental over many decades, and the impact of these changes on cash flows and stock prices in the energy sector are not likely to be seen for many years.

Maximizing return, minimizing risk

As fiduciaries, most of our institutional clients are concerned with their responsibility to maximize the investment return of their portfolios to best meet the obligations to their beneficiaries. As a portfolio manager, our primary role is to support the investment obligations of our clients while controlling the risks assumed by the portfolio. To achieve this objective in an equity portfolio, it is important to evaluate the full investible universe of stocks.

One sector of particular focus is Canada's energy sector, a fundamental part of Canada's economy and a significant constituent of the Canadian stock market, where energy represented 21% of the S&P/TSX Composite Index at the end of March. The energy sector offers a significant opportunity to enhance the value-added potential of a Canadian equity portfolio over the long term given energy's historical outperformance through several business cycles.

The following table compares the performance of some blue chip Canadian energy companies to that of the broader market index over the last 15 years. Even after the recent oil price correction, these stocks have greatly outperformed the index.

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Company	15-year cumulative total return to March 31, 2015
Canadian Natural Resources	833%
Imperial Oil	507%
Suncor	450%
S&P/TSX Capped Energy Index*	285%
S&P/TSX Composite Index	**124%**

** The return of the S&P/TSX Capped Energy Index prior to March 29, 2002, excludes dividends.*

Source: Bloomberg

While some observers have suggested investors take a moral stand by removing energy companies from their investment portfolios, such divestment will not expedite the arrival of lower carbon emissions since there are very limited viable fossil fuel substitutes. Moreover, current estimates[1] project a steady growth in demand for oil - from 93 million barrels a day in 2014 to 104 million in 2040 - driven largely by projected increases in consumption in the developing economies of Asia. Oil production will be required for some time to come, and higher demand and limited alternatives will result in an increase in carbon reliance regardless of how many investors sell their energy holdings.

Our long-term equilibrium oil price target is about $80 U.S. per barrel, a target that considers:

- declining oil supply outside North America
- a modest increase in global consumption

Oil at $80 may do more to achieve sustainability goals than legislated initiatives since higher oil prices will drive further energy conservation among consumers, encourage substitute clean energy alternatives, and ultimately reduce fossil fuel demand.

Even with potential new regulations, we have analyzed the Canadian energy companies in our portfolio and have found that they are attractive using a variety of pricing scenarios.

We don't believe the energy assets of the companies we own will be stranded. We think that excluding the energy sector would significantly reduce the universe of Canadian stocks for inclusion in a Canadian equity portfolio and would impair the value-added potential of the portfolio.

[1] *Source: International Energy Agency World Energy Outlook 2014*

Our approach to evaluating energy stocks

We evaluate environmental and regulatory risks in the energy sector the same way we evaluate these risks in other sectors: as two key factors we seek to manage when building prudent investment portfolios. In fact, we actively assess a broader set of environmental, social and governance (ESG) considerations in our analysis of each security we buy and own.

ESG is an essential part of our analysis since the components of ESG can negatively impact a position we hold. As a result, ESG factors are an important element of the Investment Grade Checklist we use to assess securities.

Our internal research teams assess ESG factors by applying their in-depth knowledge to companies and industries. We also subscribe to a third party service, Sustainalytics, which we use as an independent external source to ensure that we do not overlook any relevant considerations.

When assessing the risk of stranded carbon assets, there are a number of long-term issues we carefully consider, including:

- potential supply side improvements that could reduce future environmental impacts
- the emergence and development of renewable alternatives
- energy efficiency initiatives driven by changes in global supply and demand
- shifting policy changes regarding carbon-based fuel consumption by countries and political leaders

Our investment analysts are constantly evaluating these factors and assessing their impacts on valuations and risk levels. We assess the potential of new regulations impacting production and profitability levels based on the likelihood and expected financial impact on each company in the industry. We evaluate this type of risk in the same manner we assess the likelihood and impact of a change in CRTC regulatory policy on media and telecommunication companies. We also consider and model potential changes in carbon tax policies to ensure that the investment thesis in our energy stocks remains attractive under different scenarios.

For example, we factor into our valuations the current cost of revised regulatory carbon restrictions in Alberta, where today's tax of $15 per tonne will rise to $30 per tonne in 2017, equivalent to less than half a cent per litre of gasoline at the pump. We estimate that these higher carbon taxes will have very limited impact on oil company profitability.

We also assess the potential unique risk associated with individual companies within the energy sector. For example, companies with a large reliance on coal production for energy use are most at risk of environmental regulation. Instead we favour companies which are large, well-capitalized oil producers with robust long-term reserves, low costs to replenish these reserves, and strong ESG track records. Companies like Suncor and Imperial Oil which meet these criteria are better able to withstand short-term fluctuations in oil prices and are well positioned to benefit from normalizing oil prices. At FGP, we look at the increasing cost of carbon reduction as but one element of a company's risk assessment.

Our conclusion

The risk of stranded carbon assets will not, on its own, dissuade us from investing in a company or in its broader industry sector. However, we incorporate this risk with a range of other financial factors in our valuation process to assess the relative attractiveness of different investment opportunities. In this manner, we try to capture all relevant inputs and risks in our security-level decisions in order to maximize the investment performance of our clients' portfolios, while prudently managing investment risk. To truly achieve these objectives over time, we feel that it is important not to exclude significant and essential sectors of the economy but rather to properly evaluate and price risk in the context of our fundamental analysis of securities.