Franklin Bissett Energy Corporate Class

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Quarterly Commentary

Investment Team

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Fund Description

The Fund seeks long-term capital appreciation by investing primarily in equities and other securities of Canadian entities involved directly or indirectly in the energy sector.

Fund Details

Inception Date	06/14/2007
Benchmark	S&P/TSX Capped Energy Index, S&P/TSX Composite Index

KEY POINTS

- The Canadian energy sector failed to match its strong performance in the previous quarter in Q3, hit by a wave of pessimism following the adverse ruling on the Trans Mountain pipeline expansion project.
- Although it outperformed the benchmark, the fund delivered a negative absolute return in the third quarter of -5.8% (Series A, net of fees).
- We are encouraged by the strengthening of commodity prices, particularly crude oil and consider the upside potential in the energy sector to be significant given prevailing low valuations across much of this group.

PORTFOLIO MANAGER INSIGHT

Market Review

In the third quarter of 2018, the energy sector was unable to keep up the momentum generated in the prior period and gave back much of the gains from the second quarter. This occurred despite WTI crude oil remaining within a relatively tight price band (US$67-72/b for much of the time) and NYMEX natural gas showing some late quarter strength. We attribute the weakness in the equities to two primary factors: first, the widening pricing differentials (vs. benchmark) for western Canadian oil and gas due to egress challenges; and second, a wave of pessimism in the market following the adverse Federal Court of Appeal ruling on the Trans Mountain pipeline expansion project. While underlying fundamentals for the commodity benchmarks are supportive, local transportation issues are offsetting much of that potential positive impact on realized energy producer cash flows.

Performance Review

Although it outperformed the benchmark, the fund delivered a negative absolute return in the third quarter with -5.8% return for Series A. Generally speaking, holdings in the utility and industrials sectors aided relative performance, offset by weaker performance in energy.

The fund ended the quarter with a total of 44 securities with a portfolio-weighted-average market capitalization of approximately $10.5 billion compared to a weighted-average market capitalization of $32.3 billion for the S&P/TSX Capped Energy Index (SPTSXCEI), highlighting the larger number of small- and mid-cap securities in the fund and contrasting to the influence of a few large index constituents in the SPTSXCEI (notably Suncor and Canadian Natural Resources, which together accounted for 47% of the SPTSXCEI as at September 30, 2018).

The fund remained overweight the service sector, with approximately 19% of its assets allocated to oilfield service (OFS) entities compared with just under 6% for the benchmark; however, we would note that this OFS subsector weight remains lower than it was prior to the start of the energy sector downturn in 2014. Over the years, the fund has built up a notable position within the energy infrastructure & utilities groups (just over one-quarter of the portfolio at end of September), which although it is a large proportion of the energy & utilities GICS sectors of the S&P/TSX Composite, is not represented within the SPTSXCEI.

Performance (%) as of 09/30/2018

	1 Month	3 Mths	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Inception (06/14/2007)
Series A	-2.43	-5.77	-6.55	-9.68	-3.08	-12.61	-0.98	-3.01
S&P/TSX Capped Energy Index	-2.17	-5.73	2.02	4.12	7.71	-3.38	-1.99	-2.65
S&P/TSX Composite Index	-0.89	-0.57	1.36	5.87	9.70	7.81	6.30	4.25

Indicated rates of return include changes in unit or share value and reinvestment of all distributions and dividends and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Please refer to the prospectus for further details. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. **Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.**

Holdings that delivered significant positive relative returns from an attribution perspective included Horizon North Logistics (+13% return in the quarter), Capital Power (+15%), Akita Drilling (+24%), Secure Energy Services (+17%), and Tamarack Valley Energy (+9%), all of which added more than 25bp to relative performance. Holdings detracting the most from relative performance were Pieridae Energy (-28%), AltaGas (-20%), BlackPearl Resources (-19%), Trican Well Service (-23%), and ZCL Composites, all of which detracted from performance by more than 20bp. Being underweight Canadian Natural Resources (-10%) added over 90bp of relative performance, while avoiding MEG Energy (-27%) added over 20bp. Conversely, not owning Husky Energy (+11%) cost nearly 50bp of relative performance, and not owning Encana (-1%) cost over 30bp. For the first time in some time, Suncor was not a material factor in relative performance, as its shares essentially paced the benchmark return this quarter.

During the quarter, portfolio holding Xtreme Drilling was acquired by Akita Drilling (another existing portfolio holding) in consideration for cash and shares of Akita. In addition, we eliminated our positions in Crescent Point Energy and PHX Energy Services Corp as we saw better opportunities elsewhere within the portfolio. Despite the negative price movement for the sector and the fund, some securities showed notable strength at times during the quarter, and we took some profits by trimming shares of Gear Energy, Kelt Exploration, Tamarack Valley Energy and Capital Power. Although we did not establish any new positions this quarter, we added to certain holdings on weakness, namely Advantage Oil & Gas, AltaGas, Cenovus Energy, CES Energy Solutions, Peyto Exploration, Trican Well Service, and ZCL Composites.

Benchmark crude oil prices have recovered significantly from the lows of more than two years ago, and we note that WTI crude oil recently touched US$75/b, a level not seen since November 2014. However, we believe most management teams remain cautious in setting their capital expenditure plans. Localized pricing differentials may take some time to fix (for crude oil and for natural gas), and so we feel that this caution is prudent. Investor sentiment remains lacklustre for Canadian energy equities. One of the principal reasons for this funk is takeaway capacity constraints, which have resulted in reduced pricing for domestic production at point of sale. Various grades of Canadian crudes have traded at wider discounts to WTI reflecting pipeline apportionment and the higher cost of transporting excess crude by rail. Canadian gas at AECO is substantially lower than NYMEX pricing (adjusted for currency and tolls), due to pipeline constraints, principally in the TransCanada system. These effects have not only reduced producer cash flows, but poor investor sentiment has made accessing the equity markets difficult, resulting in a moderated spending outlook that is close to cash flow in many cases. This scenario necessarily focuses companies to be more focused on return on capital and profitability (rather than growth) – a focus that we believe should be positive for shareholder value – but it may take some time for this stance to be rewarded.

Outlook & Strategy

There are some positive signs on the horizon, including the positive final investment decision by Royal Dutch Shell and its partners in the LNG Canada project (announced subsequent to quarter-end), additional crude by rail contract announcements (most notably by Cenovus for 100,000 b/d in September), and increasing demand for crude oil and natural gas (the latter occurring despite temperate weather). We are becoming more positive on the space as a result but would obviously prefer to see some of the transportation bottlenecks resolved.

We expect that opportunities presenting themselves now will provide for significant future returns as the business cycle normalizes. We therefore continue to have a positive long-term view of the sector. We are encouraged by strengthening in commodity prices, particularly crude oil and consider the upside potential in the energy sector to be significant given prevailing low valuations across much of this group.

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