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Steve Palmer: Go Long on Oil Equities

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AlphaNorth Asset Management President and CEO Steve Palmer believes further economic growth in China and the ongoing economic recovery in the U.S. will send oil prices over \$100 a barrel in the first half of 2011. But he picks his oil equities knowing the oil price will play only a small role in determining any share-price appreciation. For him, it's about getting in early on companies with reasonable prospects for massive gains. In this exclusive interview with The Energy Report, Steve shares three of his favorite oily names with outsized potential.

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The Energy Report: Briefly tell us about AlphaNorth Asset Management.

Steve Palmer: AlphaNorth Asset Management manages the AlphaNorth Partners Fund, which is a long-biased, small cap-focused hedge fund that just finished its third year in business. In 2010, we launched our first flow-through offering—the AlphaNorth 2010 Flow-Through Limited Partnership.

TER: Are there many flow-through funds like that out there, or are you carving out a niche for yourselves?

SP: We're carving out a bit of a niche for ourselves, in terms of performance. There are dozens of flow-through funds.

TER: How is that fund performing to date?

SP: Extremely well. The net asset value (NAV) per unit was \$16.42 at the end of November. The initial NAV was \$10. We had two closings—one in March, one in April. We do not pay premiums for the flow-through shares, as flow-through funds usually pay a premium, and we actually averaged a discount. Our lawyers have advised me not to talk about returns because the AlphaNorth 2010 Flow-Through Limited Partnership has not been around for at least a year. I guess people have to figure out the difference between \$16.42 and \$10 on their own.

TER: You invest mostly in Canadian companies listed on the TSX or the TSX Venture Exchange, both of which witnessed big gains in early December. A week later, however, profit taking was dampening some of that enthusiasm. Do you believe taking profits is the correct approach currently, and are you doing the same?

SP: No, quite the opposite. I've been quite confident that December will be a strong month. In my recent commentaries, I've noted that December is typically the strongest month of the year for Canadian small caps. If you look at the BMO Small Cap Total Return Weighted Index over the last 25 years, on only one occasion was it down in December.

TER: To a certain extent, you believe in market timing and the seasonality of the markets. You firmly believe the markets usually slow down in the summer and pick up again in the winter, at least here in Canada when the registered retirement savings plan (RRSP) cash flows in. Could you comment on that and your approach to timing market seasonality?

SP: I'm definitely aware of seasonality, but that's just one factor I consider when making investment decisions. When May comes around, for example, I'm not going to sell everything in the portfolio and go 100% cash. However, I'll be much more cautious at that point.

TER: Are you buying now?

SP: I've been fully vested since August, so I'm taking profits on some positions. I'm always buying and selling, taking profits on some and reinvesting in others with a better risk/reward balance. I intend to maintain a higher-than-average long position going into the new year.

TER: In a recent research report, you said cash is flowing out of equity mutual funds and into bond funds but you expect the situation to reverse. What's going on there and how is that phenomenon showing up in the market?

SP: Cash has been going out of equity mutual funds consistently for over a year. It's been piling into bond funds. I think investors are still focused on capital preservation as opposed to trying to earn an investment return. Investors are still very cautious. They lost a lot of money in the equity markets in the 2008 meltdown. A lot of people remember it quite vividly and are scared to put money back into equities.

TER: Is that creating some buying opportunities for you?

SP: Yes, it is. Ultimately, as the equity markets continue to do well, those people are going to come back. I'm starting to see that. I don't consider it much of a return when you can invest money and get only about 2%–3% for an entire year. There's a lot of risk in that. If you're a long-term investor, it makes no sense.

TER: I agree; 30-year Canadian bonds are selling at about 3.5% right now. That won't even keep pace with inflation.

SP: If inflation goes up, there will be a huge loss on those. Not a lot of people realize that you can lose money on a bond.

TER: You said investor reluctance is presenting some buying opportunities. Where are you finding value right now?

SP: Well, there's no particular trend. Recently, I've been focused on oil and uranium.

TER: About half of your equity positions are in resource-based companies. You said the other half is in technology and similar plays. How much of that 50% is in gold, oil and gas (O&G) and base metals?

SP: Due to some pretty strong performers in the resource space, that weighting is closer to two-thirds resources now. I will be reducing that over the coming months; but of those two-thirds, about 40% would be in energy, 20% base metals, 20% precious metals and 20% rare earth elements (REEs).

TER: You've said you're short on COMEX Gold. Are you long on oil?

SP: I'm long on a lot of junior oil equities but not on the commodity itself.

TER: Where do you see the oil price as long as five years out? Are we getting over \$100?

SP: I think so; I think it will be over \$100 in the first half of next year.

TER: What do you base that on?

SP: Continued strength in the markets and the economy and the fact that most forecasts are much lower.

TER: Do you believe now is a good time to buy junior oil companies?

SP: I believe so, but I like to buy companies that are not dependent on the oil price. I like to buy companies with attractive odds for discovering something big. I try to take the commodity aspect out of it because the hardest part is to predict where commodity prices will go. I focus more on the company's specific prospects, but it's always good to have the commodity working in your favor.

TER: Where are you with gas? Are you buying small O&G companies because they may be undervalued right now?

SP: No, I haven't yet. The key there is timing. At this point, what will turn the gas price around in a meaningful way is not apparent. Buying small-cap natural gas companies hasn't been a focus; but, at some point, opportunity will be there.

TER: Tell us about some O&G companies that have performed well for your fund.

SP: One company that has performed very well for us is [Primary Petroleum \(TSX.V:PIE\)](#)—a land play that's developing in Montana. We bought it at \$0.08 and it's trading at around \$0.84 now. One of the most attractive formations that companies are going after now is the Bakken. And the Bakken has been identified in Alberta. The theory is that it extends south into Montana.

Over the last several months, large companies have done a lot more work in that area and seem to be having some success in proving that theory. Primary was very early to assemble a large position there in Montana. Companies like [Rosetta Resources Inc. \(NASDAQ:ROSE\)](#) and [Newfield Exploration Company \(NYSE:NFX\)](#) have acquired significant land positions in Montana not far north of Primary's land. They've been drilling wells and one of the wells is in production now. They're in the process of acquiring more land, so the evidence continues to build that Primary's land could be very valuable.

TER: Primary has not yet tested its land but neighboring land is coming on at high production levels. Is that correct?

SP: We don't yet know the production capabilities. What neighboring companies are achieving has all been very secretive up to this point; but actions are telling the story. They're acquiring more land and expanding their drill programs. They wouldn't be doing that if they weren't getting good results from the initial wells.

TER: Has that theory led you to increase your position in Primary?

SP: Initially, I bought in at \$0.08 in a private placement. It wasn't as much as I would have liked, so I began buying it aggressively in the market at \$0.10–\$0.15. I bought stock all the way up to \$0.60.

TER: And you're just holding it now. I guess that means you believe there could still be some appreciation ahead.

SP: Yes. If it's proven that the Bakken extends onto Primary's property, the company is worth several dollars a share. That's the minimum.

TER: Steve, what are some other oil and gas companies that excite you?

SP: [Canadian Overseas Petroleum Ltd. \(TSX.V:XOP\)](#). I'm excited about that one; it's one we purchased in a recent private placement.

TER: Tell us about the company's projects.

SP: Canadian Overseas raised \$130 million when it was valued at only \$12 million, pre-financing. Its projects are all in the North Sea, where companies have been operating for decades. So, it's all a very well-known process—no different from western Canada, really. XOP will begin drilling those projects in March. The management team has a good track record of finding oil in the area; it has drilled five exploration wells before, four of which were successful. The P50 number for recoverable oil on its prospects is more than 100 million barrels (Mbbbls.).

TER: Please explain to our readers what P50 means.

SP: The 'P' stands for probable and '50' represents the odds percentage. So, for Canadian Overseas, it means there is a 50% probability that 100 Mbbbls. are there. If the company were to find 100 million barrels, it would be worth more than \$1 billion. Right now, it has a market value of roughly \$180M.

TER: What are the risks?

SP: XOP could be unsuccessful in its drill programs and/or the oil price could decline making its projects less economic.

TER: Are there any other oil plays you like?

SP: There's [Simba Energy Inc. \(TSX.V:SMB\)](#), which is a very early stage company that's assembled some land that's highly prospective for oil on Africa's west coast. Oil seeps all over the land, indicating that oil is there somewhere. A couple of major oil companies are drilling very nearby offshore.

TER: What's Simba trading at right now?

SP: It's trading at \$0.08 a share; I got in at roughly the same level. Currently, the market cap is around \$7 million.

TER: What will be the next catalyst there?

SP: The company is working to attain a production-sharing agreement from the government to drill on its property. That should come sooner than later but it's very hard to predict with African governments, particularly those where Simba is operating—Mali, Liberia and Ghana. It may get done, but it may never come—that's why it's a \$7 million company.

TER: You must like either the thesis or the management?

SP: The thesis makes sense. Another company with a similar business plan is [Centric](#)

[Energy Corp. \(TSX.V:CTE\)](#), which was pursuing oil in Africa also. [Africa Oil Corp. \(TSX.V:AOI\)](#) offered to buy Centric for \$60 million on November 29.

TER: Do you have some parting thoughts on the O&G sector currently? What investors can expect over the next five or six months?

SP: Well, my market call on oil is that it will trend higher over the next five to six months. Gas is much more uncertain, so I don't particularly have a view on gas at this time. But the risk to the oil price is Asian growth rates.

TER: And to a certain extent a continued recovery in the U.S.

SP: A continued recovery, yes; but obviously it's going to be a slow recovery.

TER: How do you recommend people play oil and gas?

SP: Find good companies and get in at good valuations or through our fund. A lot of people don't have time or the expertise to identify the best prospects in the energy space.

TER: But the minimum investment in your fund is \$150,000, right?

SP: I can waive that amount, and I have been accepting lesser amounts.

TER: Thank you for talking with us today, Steve.

SP: You're welcome.

Steven Palmer, with 15 years of experience in the investment industry, has been the president, CEO and a director of [AlphaNorth Asset Management](#) (AlphaNorth) since founding the firm in the fall of 2007. The company currently manages a long-biased, small-cap hedge fund. Prior to founding AlphaNorth, Mr. Palmer was employed at one of the world's largest financial institutions as VP of Canadian equities, where he managed assets of approximately \$350 million. He managed a small-cap pooled fund from its inception in August 1998 to August 2007, achieving returns that Morningstar Canada ranked #1 in performance (35.8% over nine years versus 10.0% for S&P/TSX Composite Index and 13.0% for the BMO Weighted Small Cap Total Return Index) over the same period. Mr. Palmer also managed a large-cap fund that ranked in the first quartile of performance for years 1–5 and 10 at the time of his departure in August 2007. Prior to this, he worked as a portfolio manager at a high net-worth investment boutique. Starting his career as a research associate in January 1995, Mr. Palmer quickly progressed to research analyst. He has a BA in economics from the University of Western Ontario and is a CFA.

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