Dear Investor Friends,

We manage €155 million in our three Funds. Up slightly since the beginning of the year, but down significantly over the past month. This is not too serious for those of you who have been with us for a few years, or even a few months, but our sincerest apologies to those of you who put your trust in us for the first time only a few weeks ago. I wrote something very similar in 2002, to those who had lost over 25% between April and October of that year. But that's how it is; not much we can do about it. The good thing about investing in the stock market is that you are mathematically certain to lose between 20% and 40% of your investment some day, if you wait long enough for the next crash that will undoubtedly arrive. In order to not lose like Mr. Market, you have to know how to prepare yourself psychologically. Keynes was a great economist, and a fabulous investor. Here is what he wrote in 1937, after the market plummeted 50% in 6 months: "I consider it the duty of every serious investor to suffer grievous losses with great equanimity."* I must admit, over the past dozen years, I have suffered my share of grievous losses. And sometimes I made a huge profit from buying low, a favourite sport of value investors.[1]

Oil and Volatility

As you know, we have been heavily invested in the oil sector since the end of 2004. We have made a nice living off of this bet, despite the fact that the prices of our stocks have fallen sharply in the past month. Indeed, much more than the indices; as much as 30% for Canadian Natural Resources, our largest holding. At the time, it seemed like a win-win situation, in that we would come out ahead no matter what happened. If the price of oil rose, we would make loads of money, if the price of oil stayed where it was, we would make loads of money, if the price of oil fell, we wouldn't lose anything, and if the price of oil completely collapsed, well, I wouldn't die.[2] In short, what mathematicians call a positive expectancy.** And that is our job as investors, to make long-term bets with a high positive expectancy.

So we placed our bets on oil companies, without making any bets on the price of oil itself. Then we did our due diligence as investors. We dug deeply into the subject, read books on the history of black gold, studied the geopolitics and economics of this source of energy, visited companies, met with consultants and geologists, etc. And we came out of it all with a very simple idea, if not fairly obvious: oil is a disappearing commodity, but nobody knows exactly when we will run out. Tomorrow? In 40 years? Before or after those genius scientists find a new, abundant, storable, and unlimited replacement energy source?
In our opinion, what matters here is not so much the answer, but the question. And the real question is not whether we have reserves for the next 30 or 100 years, but at what pace the oil companies can produce. Every day, humans consume an astronomical 85 million barrels of oil. An amount that has been increasing by 1.8% annually since 1996. Imagine what would happen if global oil production can't exceed this volume. Nobody is talking about the end of oil, yet this would be a true economic catastrophe. Growth would be brutally halted. As of now, there is no alternative energy source available. The Chinese, the Indians, the Brazilians will want to drive cars, fly in planes, and use plastic packaging, just as we do, so we will have

[1] See our June 2002 newsletter, "He who loses wins." But for the equanimity, I'm not so sure…
[2] See our April 2005 newsletter, "Fortune tellers and the price of oil."

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to share with them. There are two ways to share a rare commodity in a cruel world. Either pay more for it than your neighbour, or steal it, gun in hand…. also known as going to war.

So what matters is not the answer, but the fact that today, the question is being asked by highly responsible, well-informed people without any particular economic interest. Such as Pierre-Henri Guyon, a scientist quoted by the remarkable magazine, Nautilus, “Today’s young generation will live through an extraordinary era, because they will have to face the end of a world. Oil energy will become rare, the entire economic system will have to be reinvented, they will have to learn how to handle climate change, decisions related to biotechnology… They won’t be idle. But what panics me is that they are so ill-prepared.” Bothersome, isn’t it?

Some people should be asking the question more than others; for example, the leaders of OPEC countries, such as Saudi Arabia. Saudi Arabia is a vast desert with 30 million inhabitants. I recently read, in a much more professional, much more American magazine, Forbes, an interesting comment made by a major Saudi businessman, “I would rather sell 8 million barrels at $90 than 12 million barrels at $50.” Makes perfect sense. But that’s not what the Western newspapers have to say. In early 2006, the very professional Financial Times explained that the Saudis should (out of a sense of moral duty) increase their production, and to do this, invest over $20 billion. I’m not so sure that the businessman quoted in Forbes would agree. Give $20 billion to what are mostly Western countries, to sell a rare commodity cheaply to essentially the same Westerners… I don’t know if that is imperialism, but it is economically stupid.

The Peak Oil Theory

In the 1950’s, a American geologist named King Hubbert dared to say that US oil production will plateau some time around 1970. Nobody believed him at the time, because production had been booming for almost a century. We often tend to believe that things that have been going on for a long time are eternal. But in December of 1970, US production hit an incredible 10 million barrels per day, which was unfortunately a record. Today, the US produces 6 million barrels per day. The same principle holds true for all oil wells. Production increases year after year, reaches a plateau (the “Peak Oil”), then drops unrelentingly. King Hubbert applied the same reasoning on a country level to the United States. Today, the big game among geologists is to try and figure out when we will reach the global Peak Oil. The most “serious,” i.e., those who don’t want to stick their necks out, claim that the Peak Oil will occur in 20 or 30 years, at a production well above 100 million barrels per day. Others, more nonconformist but not necessarily more accurate, claim that the Peak Oil will occur… between 2006 and 2010! In other words, today, as far as the financial markets are concerned. I must admit, I’m not terribly keen on trying to predict the exact Peak Oil date. But I do predict that it will arrive one day. So we not are taking many risks, and I will explain how a bit further down. Meanwhile, here is another, more personal theory.

What's good for human kind is good for the Sextant investor

Politicians would like to see the price of oil drop. But politicians also want to get re-elected, and are not terribly concerned with what could happen in 20 years, or even after the next election. But in my view, it only seems logical that oil prices should be high for the good of human kind. To finance research for new energy. To explore for oil further, deeper, at a higher cost. To encourage Western consumers to use less, by paying more attention and chasing out waste. The lower the price gets, the less we search for alternatives. The lower the price gets, the more difficult it will be to transition to other energy sources and lifestyles. The lower the price gets, the more we become intoxicated by its consumption and the less future generations will have (less oil, but also less alternative energy that won't be discovered for economic reasons.). And finally, the lower the price gets, the more brutally it will rise and we discover how unprepared we are for major changes or dire events (attacks in Saudi Arabia, wars in Iran and Africa, hurricanes in the US, etc.).

As I am hugely optimistic in the future of the human race, I would prefer to bet against the wishes of politicians (or "political personnel" as the great, unparalleled investor Edouard Carmignac calls them). It is worth noting that there does exist a government that thinks along the same lines, and that carries a bit of weight on this planet. It's the Chinese government. I just recently read in Les Echos that the China Daily is thrilled about the surge in oil product prices in its country. The economist Robert Blohm defends the price hikes, stating "The most effective and fastest solution to high world oil prices is high world oil prices." Odd? Not at all. Let's return to the article in Les Echos. "Robert Blohm …. gives a long list of benefits for China stemming from the seventh increase in domestic prices for refined oil products since 2005. These price increases encourage people to use less energy, prompt research into renewable energy, and make the Chinese economy more efficient by generating savings that can be reinvested into other sectors. They also increase China's national security by making the country less dependent on imported oil." QED. May be I should join the Communist Party.

Our oil investments:

protection against higher oil prices and an excellent growth reservoir

Announcing that Peak Oil is imminent constitutes a militant ecological and civil act. If the "political personnel" would be willing to listen to us, we would be happy to do it. Granted, there is a slight chance of reaching it in the short-term, but we are certain to reach it in the long-term, and the sooner we get there, the more catastrophic the consequences. Politicians don't want to get ready for it, no more than the consumers hiding behind them, so given all that is at stake, it seems that we need to do it ourselves. I don't want to panic Mr. Guyon any further. The Sextant investor will be ready.

Canadian Natural Resources (CNQ) is a fabulous company. It was formed a little over 20 years ago with $1 million, and today has a market cap of C$30 billion. CNQ is a true growth stock, whose management has built an excellent portfolio of oil and gas reserves. Even better

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still, these reserves are still largely unexploited. The company has 5 million hectares housing vast gas reserves. And the icing on the cake is the Horizon Project. This project involves developing a huge oil sands deposit over several years and with billions of dollars of investment. Production will begin in 2008, and should reach almost 500,000 barrels per day by 2015. The company's total production is expected to go from 550,000 barrels per day in 2005 to over a million barrels per day in 2015, with a gradual ramp-up. The Horizon Project, unlike traditional oil fields, should be stable for around 40 years. In fact, it is an open pit mine with sands that can be easily recovered, rather than a well extracting hydrocarbons embedded in more or less permeable rocks.

Warren Buffett confessed that when he researches a company, he prefers to ignore its price, so that he can determine an unbiased amount for what he would be willing to pay. In all honesty, for a company like CNQ, with its strong past growth, excellent visibility, and prospects for future growth, I don't think a P/E ratio of 13 is reasonable for 2007. We came up with a P/E of 13 because we are conservative, and are basing our calculations on oil at US$55 per barrel. Our famous safety margin. With oil at US$70 per barrel, the P/E would only be 10. I get the shivers just writing it! There is another way to value CNQ, which I read about in a recent interview with the fund managers at FairHolmes Capital. These guys have been doing wonders over the past seven years using Buffett-style management. CNQ has 9 billion barrels of bituminous sands reserves in the ground. If we value these reserves at US$12 per barrel, CNQ is worth…. enough that the FairHolmes managers didn't want to state the figure. We did the calculation at US$2.5 per barrel in the ground, which valued CNQ at C$110 per share, or double its current price.

So there you have it. We think CNQ is an excellent growth reservoir, even if oil falls back down to $40. And if there truly are problems with oil supply, if producers can't keep pace with demand, then CNQ will be a colossal hedge for us against a market downturn. In the long-term, at least. Because in the short-term, the market could pull everything down in its wake. For the past month, the markets have been fretting over rate increases (justifiably so, perhaps, but I doubt it), especially in light of the skyrocketing oil prices that may serve to drive up inflation. Given that everything is lower this month, except oil prices, why have oil companies suffered so heavily? And what would happen if oil fell to $60 or $50? Actually, the markets are already anticipating a correction in oil prices, and are selling whatever has posted the highest gains over the past few months. Too indiscriminately, in my opinion. Unfortunately, I think that this volatility, new to our Funds, is the price to pay for being positioned to benefit from the amazing growth of companies like CNQ, and to hedge against the most extreme risk that the world could face in the next 30 years: that there will not be enough oil to run the refrigerators and cars of billions of consumers and continue polluting our beautiful planet. Mr. Guyon is not an eccentric, "Oil energy will become rare, the entire economic system will have to be reinvented…" Yes, but when?
Whenever it does happen, Amiral Gestion will be ready. Even if it won't be for quite a long time; even if, to quote Keynes once again, in the long-term, when we are dead!

Meanwhile, you can count on your team to work hard, get back on its feet, and face the new headwinds.

One last thing. I am not a very good market timer. But I am going to buy Sextant. That's just how I am. Long live the sales!

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François

* I read this story in an interview with Bill Miller (one of the best fund managers in the world) that appeared in *Outstanding Investor Digest*. Bill Miller is speaking; let's listen to the master.

> This Keynes story is from 1937. Keynes was long on margin in his personal account, and he was long in his endowment, as well. And the market began to drop very rapidly, falling almost 50% in the first six months. And so he began to get these letters that said, "Don t you think that you should reduce your exposure as the market s falling?" He finally got exasperated and sent a memo back saying, "I wouldn't consider it improper to own a few shares at the bottom of the market. Your apparent investment approach is that I should be liquidating as the market gets more attractive, and that I should be buying as it goes up." He then said what I thought was a great line, "I consider it the duty of every serious investor to suffer grievous losses with great equanimity." So I have a lot of experience with the former - and I'm trying to cultivate the psychological state that he was recommending.

** Positive expectancy, or mathematical expectancy. We talk about it, but what exactly is it? This is the formula:

$$Expectancy = R_1 \; x \; P_1 + R_2 \; x \; P_2 + R_3 \; x \; P_3 + \ldots + R_n \; x \; P_n$$

Where R_1 is the gain (or loss) from event E_1, whose probability of occurring is P_1, and where

$$P_1 + P_2 + P_3 + \ldots + P_n = 1$$

(that is, the events from E_1 to E_n have a probability of 1, or a 100% of occurring).

For example, if you play heads or tails, heads you win €1, and tails you lose €1, your positive expectancy is:

$$Expectancy = R_{heads} \; x \; P_{heads} + R_{tails} \; x \; P_{tails} = 1 \; x \; 0.5 - 1 \; x \; 0.5 = 0$$

Logical, no? If you apply this to the lottery, which is much more complicated, the expectancy is negative. If you bet €1, you have a huge chance of losing €1, and a ridiculous chance of winning a fortune. But overall, you lose. Because in general, nobody ever wins the lottery.

Therefore our job is to place bets where the expectancy is highly positive, and where there are no events that could make us lose too much money (or else we would have to make many small bets, in order to not risk losing it all on account of bad luck from the outset).