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STRATEGIES FOR SUCCESSFUL INVESTING

FUND STRATEGIES

Oil and gas slowly giving way to alternative sources

ENERGY ROTATION

Richard Kang

ARE YOU INTO MINING, OIL & gas, or forestry? Probably. Canadian equity investors tend to have a significant exposure to commodity-related stocks, particularly to the energy complex. For investors who hold Canadian index mutual funds or exchange-traded funds that track Canada's main indexes, it is important to note that commodities (energy and materials) comprise about 45% of S&P/TSX Composite Index. At about 30%, energy has the largest sector weighting in the S&P/TSX Composite. There are strong macro-economic arguments, many found in past issues of *The MoneyLetter*, for the long-term appreciation of broad commodities markets, especially for oil and gold.

However, volatility can make it a stomach-wrenching ride — and the commodity markets are, if nothing else, volatile. What can investors do to profit from the longer-term global outlook for commodity demand while smoothing out the volatility that is characteristic of this sector?

I believe a longer-term view with occasional strategic shifts is the prudent path. From a purely tactical standpoint, it would have been a good move to reduce positions in oil and gold back in May. But for long-term investors, there's good reason to use a buy-and-hold approach to the commodity complex if you believe the broad global macroeconomic arguments for a bullish scenario.

Aside from occasional allocation shifts, my focus continues to be on diversification to help stabilize returns. This month, I look at alternative energy as a way to help stabilize energy exposure.

Here's the argument: As oil prices rise, a psychology of fear forces oil consumers to turn to alternative investments. The trillion-dollar question is what will be the tipping point? $100 per barrel of crude oil? $200? I don't really care. We know that economic engines all over the world will continue to demand large amounts of energy. And we know that the age of easily accessible crude oil has passed, and that new sources are more expensive to find (deep-sea drilling) and develop (oilsands). So it's only a matter of when, not if, investments in alternative energy will begin to outperform.

My advice, therefore, is to buy alternative energy right now. Again, this just makes so much more sense to us as Canadians who by nature have a home bias (this is a global pehnomenon) and probably already have large traditional energy holdings. Furthermore, alternative energy holdings should not only rise as the commodity complex (driven by oil and gold prices) rises, but more importantly, they should continue to rise when the commodity complex falls.

BUY

♦ **POWERSHARES WILDERHILL CLEAN ENERGY PORTFOLIO FUND** (AMEX: PBW; recent $18.08; prices in US dollars). This fund is one of the PowerShares Capital Management LLC family of exchange-traded funds, which in turn is the index fund subsidiary of investment giant **AMVESCAP PLC.**

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Richard C. Kang is an independent investment and risk consultant for fund management companies. He specializes in globally diversified portfolios that include both traditional and alternative asset classes. Mr. Kang is a member of the Toronto CFA Society, the CFA Institute, GARP, and PRMIA.

rckang@investmgi.com

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The Clean Energy Portfolio Fund tracks the Wilderhill Clean Energy Index, and holds a diverse portfolio of 42 stocks. Top holdings include **OM Group Inc.**, **Energy Conversion Devices Inc.**, **SunPower Corp.**, and **Zoltek Cos.** The largest sector weightings are in information technology (36%) and industrials (28%). Although the fund holds a small number of relatively "clean" utility companies, I consider it a play on Nasdaq stocks with an alternative investment bent.

I see alternative energy as a new technological wave commonly seen in major Nasdaq uptrends, and spurred by innovation. In the 1990s, for example, we saw waves in the biotech/pharmaceuticals and telecommunications/Internet sectors.

On the positive side for alternative energy, we're nowhere near the speculative state of the dot-com bubble. It's early. Still, with 42 stocks and a small-cap growth bias, this fund is significantly more volatile than the Nasdaq Composite, which is a volatile index itself! Based on this kind of volatility, PBW shouldn't comprise any more than 5% of your portfolio. ☛ ***My advice:*** Buy.

My second area of focus is uranium, an important area in alternative energy. It's almost a misnomer, because nuclear power is now more of a "traditional" energy source. There are some 440 nuclear reactors operating globally, estimated to grow to 506 by 2015. Nuclear is the third largest source of electricity, behind coal and hydro. And over 50% of global uranium production is in geopolitically quiet areas (Canada and Australia).

Uranium is still a long-term story with lots of growth potential. China alone, for example, is involved in a massive nuclear reactor development program. It currently has 9 operating reactors with 18 more in the works to be added by 2015. This growth could continue in a big way, when you consider that developed, industrial countries like France and Japan currently have 59 and 54 reactors respectively.

And all of them need a continuing supply of uranium to create the reaction to heat the steam to turn the turbines to produce the electricity. So how do you go about investing in uranium? As with any commodity I want to take a position in, I prefer a stock-based position as well as a direct commodity position. I try not to play the weights between the two, but I will make strategic shifts depending on my macro outlook. Here's what I recommend for exposure to uranium.

BUY

♦ **CAMECO CORP.** (TSX: CCO; recent $39.60). This Saskatoon, Saskatchewan-based company is the world's largest publicly traded uranium producer, and churns out about 20% of global output. The company has 550 million pounds of proven and probable reserves of the radioactive rock. It also has a 31.6% interest in the Bruce Power nuclear generating station, and a 53% interest in **Centerra Gold Inc.**

The balance sheet is strong, with a debt/equity ratio of 0.27 for the second quarter. For the quarter, Cameco posted net profit of $0.40 on revenue of $417 million. Consensus estimates are for fourth-quarter earnings of $0.22 per share and for $0.88 per share for all of 2006, up from $0.59 in 2005. The dividend has steadily increased, and is now an annual $0.16 per share for a yield of 0.40%.

The stock has had a simply stellar run over the past four years, climbing some 300%. However, for the second time this year, rockfall and flooding problems at its Cigar Lake mine have pushed back development plans by as much as a year, and share prices have slipped as a result. This is a good buying opportunity. ☛ ***My advice:*** Buy if prices fall back to between $37 and $38.

Although Cameco's mining troubles caused share prices to slip, uranium prices rose, making the next recommendation a great counterpart to Cameco.

BUY

♦ **URANIUM PARTICIPATION CORP.** (TSX: U; recent $11.33). As global demand for nuclear power continues to rise, I expect uranium to keep climbing. The recent spot price of uranium concentrate was quoted at US$56 per pound and is expected to break through US$60. Unlike gold, oil, base metals, and other commodities, there are no derivative contracts to trade uranium — prices are set privately among producers. That's where Uranium Participation Corp. comes in. Managed by **Denison Mines Inc.**, it is a closed-end fund that holds physical uranium, with the objective of long-term price gains.

As of Sept. 30, the company held 4.2 million pounds of uranium oxide and 800,000 KgU of uranium hexafluoride, for a net asset value of C$7.86 per share. The company reported revenue for the six months ended Aug. 31 at $45.4 million against expenses of $13.3 million. It remains the only way I know of to play uranium as a commodity. ☛ ***My advice:*** Buy.▼

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