

PALOS

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Weekly Commentary

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Pair Trade Opportunity in the Canadian Oil Patch

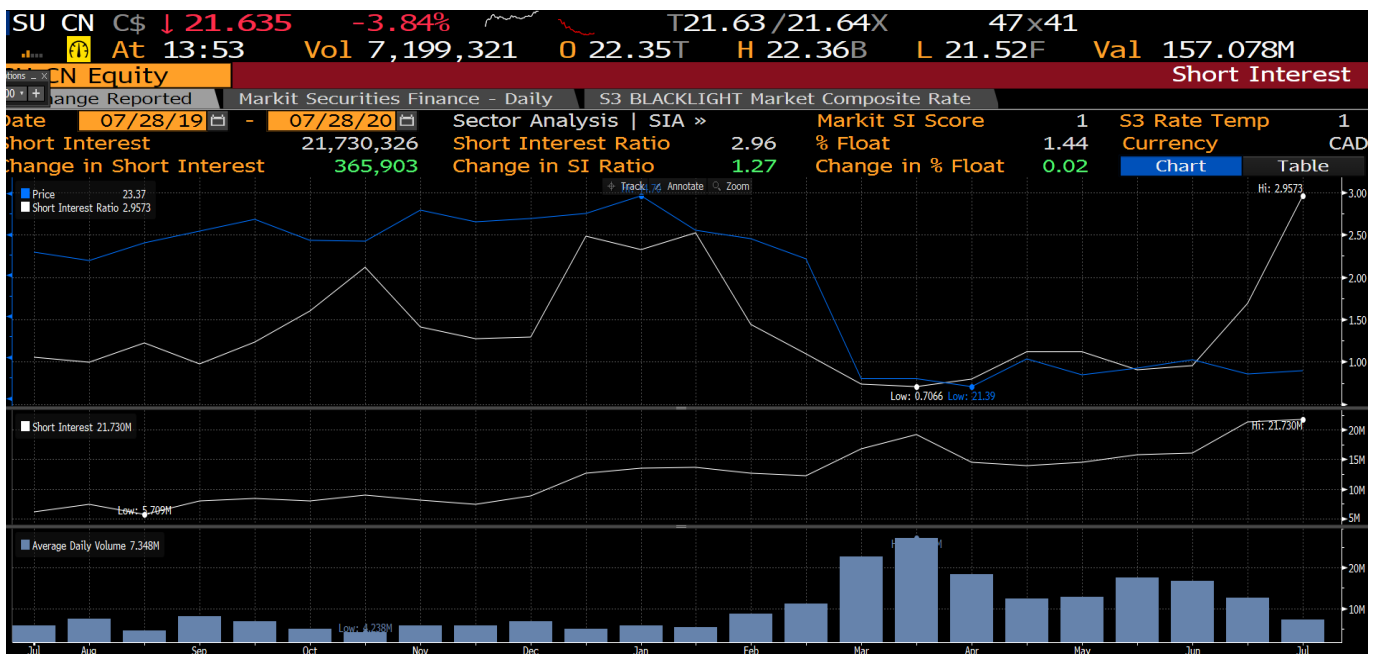
Most Canadian investors have heard of Suncor Energy Inc. (TSX: SU), Canada's largest fully integrated energy company with a market capitalization of CAD\$34 billion. The company is primarily focused on the development of the Athabasca oil sands in Alberta. Aside from extracting and upgrading raw bitumen into synthetic crude, the company refines crude oil into marketable consumer and commercial products like gasoline, diesel, jet fuel, and chemicals. Suncor also operates a vast storage, infrastructure, transportation, and retail network. With an eye on the future, SU is advancing its commitment to reducing greenhouse gas emissions by investing in low carbon technologies and wind power generation. With reserves exceeding 7.6 billion barrels of oil equivalent, SU is Canada's dominant energy company.

Pair trading is characterized as a market neutral strategy that's designed to capitalize on a divergence in price between two correlated securities. When the prices of the correlated securities become dislocated (e.g. one stock has risen while the other has fallen), an arbitrage opportunity is created. The pair trade is implemented by purchasing the security that is undervalued while simultaneously short selling an equivalent amount of the overvalued security. The expectation is that the price disconnection will eventually converge, at which point the pair trade is unwound and a profit secured.

The iShares S&P/TSX Capped Energy Index ETF (TSX: XEG) is a TSX listed exchange traded fund with a 100% concentration in Canadian oil & gas companies. Suncor (23.1%) and fellow Canadian energy giant Canadian Natural Resources (25.7%) are the two largest constituents in the ETF, accounting for almost half of the fund's \$576 million net asset value (NAV). With SU representing a significant percentage of the ETF's NAV, the correlation between SU and XEG is above 0.90. (see charts)

As you can see from the following charts (page 2), SU is significantly underperforming the XEG. In fact, the divergence is approaching three standard deviations which is an all-time high. Statistically, there is a high likelihood that this divergence will revert to a normalized spread in the near term. Further enhancing our thesis is the fact that SU is trading at 6.4x EV/DACF for 2021 where historically the company has traded between 7.5X and 8X EV/DACF. Given the positive correlation between SU and XEG, the fact that earnings risk has been removed (SU reported on July 23), and an extreme short interest being reported in SU shares, we like this trade immensely. The Palos Income Fund has implemented a long SU/short XEG pair trade to capitalize on this tactical opportunity.

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Disclaimer: Palos Funds are shareholders of SU, XEG.

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Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$7.41	-7.29%
Palos Equity Income Fund - RRSP	PAL101	\$5.35	-5.63%
Palos Merchant Fund L.P. (Dec 31, 2019) ²	PAL500	\$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	\$9.01	17.73%
Palos-Mitchell Alpha Fund ³	PAL300	\$8.39	-19.15%
S&P TSX Composite (Total Return with dividends reinvested)			-3.32%
S&P 500 (Total Return with dividends reinvested)			2.38%
S&P TSX Venture (Total Return with dividends reinvested)			25.13%
Chart 2: Market Data ¹			Value
US Government 10-Year			0.53%
Canadian Government 10-Year			0.47%
Crude Oil Spot			US \$40.27
Gold Spot			US \$1,962.80
US Gov't 10-Year/Moody BAA Corp. Spread			260 bps
USD/CAD Exchange Rate Spot			US \$0.7456

¹ Period ending July 31, 2020. Data extracted from Bloomberg

² Fund is priced annually

³ Fund is priced weekly on Tuesdays

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