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Sustainable Oil Sands Sector Index™ (SOSSI) Aug 2008 Commentary

July was a terrible month for energy investors. Energy companies that failed to benefit from the rally in crude oil and natural gas prices were hammered down when commodity prices fell during the month. The oil sands index had its worst monthly drop since October 2005 despite many companies announcing record earnings and higher dividends.

| Index | Symbol | Region | June 2008 Return |
|--------------------------------|--------------|---------------|------------------|
| NYMEX Natural Gas | NGAS | US | -31.7%** |
| NYMEX Crude Oil | OIL | US | -11.4%** |
| Oil Sands Sector Index™ | SOSSI | Canada | -14.9%* |
| S&P/TSX Capped Energy | TTEN | Canada | -14.3%* |

* Return in Canadian dollar terms.

**Return in US dollar terms.

Only one company, Connacher Oil and Gas was able to gain in July. The best performers tended to be dividend payers and companies that have current cash flow from oil sands operations. The biggest hits were taken by companies with high natural gas exposure (Encana) or are more in the development stage such as Ivanhoe Energy and Oilsands Quest.

Top Performing Stocks July 2008

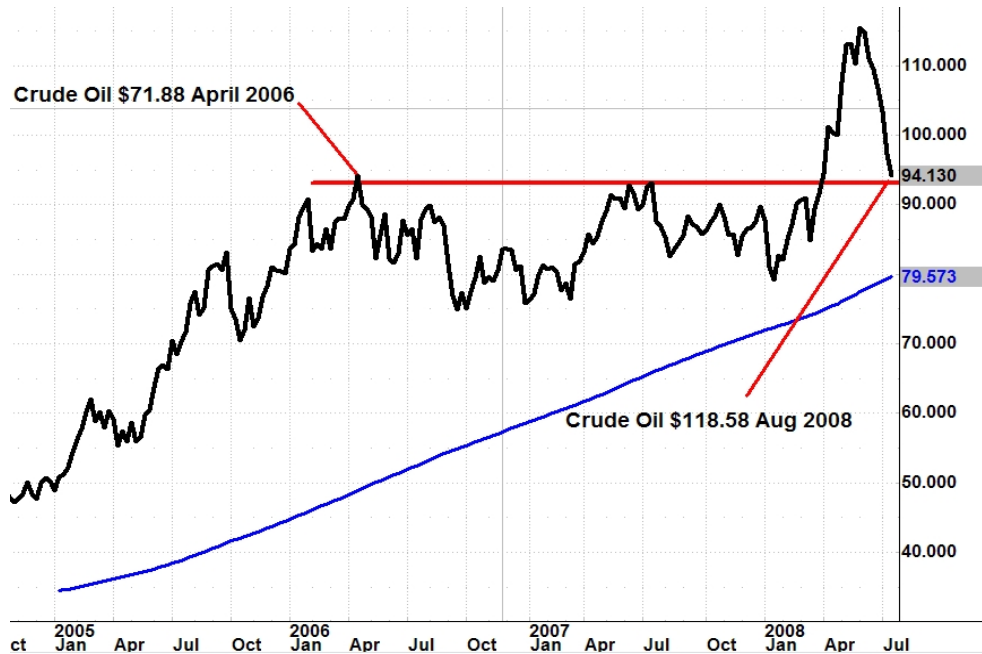
Worst Performing Stocks July 2008

| | | | |
|---------------------|-------|------------------|--------|
| Connacher Oil & Gas | 0.7% | Nexen | -20.8% |
| Suncor Energy | -6.0% | Encana | -20.8% |
| Cdn Oil Sands Trust | -6.5% | Petrobank Energy | -22.6% |
| Husky Energy | -7.1% | Ivanhoe Energy | -29.5% |
| Baytex Energy Trust | -9.5% | Oilsands Quest | -30.6% |

The chart below highlights the lack of performance in Canadian energy stocks during the crude oil bull market. As you can see, most of the gain occurred during the initial phase of the rally when crude oil first exceeded \$40/bbl. The 65% rise in crude oil over the last two years has resulted in very little return for equity investors so far. I think this is about to change.



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My belief is that several factors will reverse the poor performance of energy stocks in the near future.

Institutional Investors

Large investors have been focused on diversifying into commodities over the last number of years. This has been a sensible strategy given that the US dollar has been weak and the global demand for most commodities has been growing rapidly. The recent pullback in most commodity prices including oil and natural gas is an indication that this trend might be waning.

US Dollar & Interest Rates

The US dollar seems to have stabilized recently and is gaining against most currencies including the Canadian dollar and the Euro. The relationship between oil and the US dollar is highly correlated (inversely). I believe this shift will change the focus from commodities to the commodity producers. For example, if the US dollar gains against the Canadian dollar and crude oil prices remain stable, Canadian energy producers should maintain strong profit growth and benefit from renewed US investor interest. The chart below shows how much the US dollar has fallen in the last three years and the recent rally from the bottom.



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Cash Flow & Dividends

Canadian energy companies are benefiting from record cash flows and have been slow to reinvest the funds. Instead, most have chosen to increase their dividend to investors and buy back company shares. For example, Canadian Oil Sands Trust, Encana and Husky Energy have all increased their dividend by 300%+ over the last two years. Recently announced project delays and a lack of new investment opportunities will reinforce this trend.

I suspect that brave souls who invest in the sector now will be pleasantly surprised during the winter months as positive investment sentiment returns.

Derek Gates, CFA

Founder of the Oil Sands Sector Index™

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