Portfolio Manager Commentary - September 30, 2022

Crude Oil Review

During the third quarter of 2022, oil prices fell as concerns about worsening economic outlook weighed on demand. Oil prices reverted to January levels at the end of the quarter. West Texas Intermediate (WTI) finished the 3-month period at US$79.49 per barrel by September 30th. Brent oil prices kept trading at a premium and closed at US$87.96. In Canada, heavy oil spreads traded at a discount of US$22.00 by the end of September. The differentials continued widening during the quarter, largely a function of heavier releases from the U.S. Strategic Petroleum Reserve release of sour barrels as well as higher natural gas prices.

During the 3-month period, oil demand has peaked and started to decelerate. This was mainly due to ongoing economic slowdown in the OECD and recurring lockdowns in China. With elevated inflation and high prices across all major consumer categories, gasoline demand was relatively weak. Yet, jet fuel demand remained tight. A slight cooling of geopolitical tensions between Russia and Ukraine also helped bring the oil prices down from the months when the war and consequent sanction were on the center stage. Despite brent oil prices slipping below $90 in early September—the lowest level since January—Energy sector was still one of the best-performing sectors across major global bourses during the third quarter. Investors favor the sector's solid cash flow and return to shareholders, and view near-term demand weakness as temporary. The International Energy Agency (IEA) forecasts that the global oil demand will grow by 2 million barrels per day in 2022 and a further 2.1 million barrels per day in 2023. The forecast also expects jet fuel to lead demand growth and road transport demand to wane. Middle East and Europe's switch to oil due to record-high natural gas prices should also provide additional support for oil demand.

During the most recent OPEC+ meeting in September, the alliance decided to trim the October production by 100 thousand barrels per day, representing the first supply cut in more than a year. Even though this decision does not materially change the supply and demand dynamics, it signals that the producer group is willing to take pre-emptive actions to manage the crude market if needed. Meanwhile, Russia remains the production wildcard for the rest of 2022. The G7 meeting in September proposed a price cap on Russian oil, where buyers in third-party countries would only be able to access European insurance services to facilitate oil purchases. However, where the cap will be set and how the agreement will be enforced remain in question. Moreover, there is also uncertainty associated with supply shock stemming from ongoing nuclear discussions with Iran, strategic inventory releases, and spare capacity from Saudi Arabia and the UAE. In short, we believe supply-demand imbalance is likely to persist over the midterm. The global energy crisis would linger into the upcoming winter heating season, suggesting the potential for strong crude oil prices into next year.

Portfolio Review

Units (1 Class A share plus 1 Preferred share) of Brompton Oil Split Corp. (the "Fund") were down 2.4% in the third quarter of 2022. This compares to the S&P/TSX Capped Energy Index, which was down 4.5%, and the S&P 500 Energy Index, which was up 2.2% over the same period. Top performers included ConocoPhillips, Tourmaline Oil, and Occidental Petroleum, which returned +16.0%, +10.5% and +4.6% respectively in local currency terms. Upstream players involved in the exploration and production (E&P) process outperformed midstream players during the period.

The portfolio was rebalanced and reconstituted in late September and the number of holdings were reduced to 17 North American oil companies. We sold 2 U.S. energy service stocks and 3 Canadian E&P stocks, while we also bought 3 U.S. E&P names, adding up to 12 names in the U.S. and 5 names in Canada. We currently favor upstream players who produce oil and gas since they are more sensitive to oil and natural gas price increases. Fracking spreads and rig counts peaked in the end of July and normalized towards the quarter end. North American energy stocks continued to trade at a significant discount relative to the broader market, although the discount has narrowed year to date. On an absolute basis, the group kept trading at cycle low EV/EBITDA valuations. Thanks to the strong sector performance, investor exposure to North American energy equities has increased modestly this year but remains at low levels by historical standard. Given a solid Q2 earnings profile, the driver of share price appreciation will still be focused on free cash flow allocation, costs/inflation, and dividend/buybacks. Similar to other sectors, management comments on 2023 outlook will become increasingly important. Our portfolio is well positioned to benefit from a sustained rebound in global oil and gas demand. The portfolio holdings are primarily spread across exploration & production companies and a few integrated oils to provide investors with exposure to key resource plays that we believe have the strongest return potential.

Looking to the rest of 2022, we believe both demand and supply sides of the crude oil market will experience high volatility. Growing concerns about recessionary risk would soften oil demand, despite historical data suggesting that recessions in most cases did not lead to demand destruction. China's strict COVID policy could ease after the 20th National Congress, but the pace and timing are challenging to forecast. Geopolitics will still be the dominant driver of oil supply, while a Russia-induced energy crisis seems inevitable across Europe. With oil prices hovering at elevated levels, we expect inflationary pressure to persist, even though this would not derail the industry's strong free cash flow story. At current prices, oil producers are still exercising capital discipline and projecting low-to-mid single digit production growth. We also believe free cash flow is poised to advance further on existing capex estimates, allowing for acceleration of returns to shareholders. Even after waves of cash returns, there is still massive remaining cash flow unallocated. In this regard, we think although near-term uncertainties would blur the macro outlook, sector fundamentals remain robust and should continue to catalyze further share appreciation in the North American energy space.

Laura Lau, CIO

Michael D. Clare, SVP & SPM

Annual Compound Returns[1]	YTD	1-YR	3-YR	5-YR	Since Inception[2]
Brompton Oil Split Corp. - Unit	31.8%	43.4%	13.9%	2.7%	(1.1%)

(1) Returns are for the periods ended September 30, 2022 and are unaudited. The table shows the past performance of the Fund. Past performance does not necessarily indicate how the Fund will perform in the future. The information shown is based on Net Asset Value per Class A share and per unit, or the redemption price per Preferred share and assumes that distributions made by the Fund on the Class A shares, Preferred shares and units in the periods shown were reinvested (at Net Asset Value per Class A share and per unit, or the redemption price per Preferred share) in additional Class A shares, units and Preferred shares of the Fund.

(2) Inception Date February 24, 2015.

BROMPTON FUNDS

VALUE
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PERFORMANCE
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Investor Relations
PHONE 416.642.6000
TOLL FREE 1.866.642.6001
FAX 416.642.6001
EMAIL info@bromptongroup.com

Website
www.bromptongroup.com

Address
Bay Wellington Tower,
Brookfield Place
181 Bay Street
Suite 2930, Box 793
Toronto, Ontario M5J 2T3