

Worth. Investing.

We're all PIGS Now

Investment Update

I recently read an article in the Globe and Mail by Jeff Rubin (former Chief Economist of CIBC) entitled “We’re all PIGS now” and thought how appropriate that title was to the financial mess the developed world finds itself in currently. For those of you who are not aware the PIGS (or PIIGS as some people refer to them) is an acronym for Portugal, Italy, Greece and Spain. The extra “I” can stand for Ireland if you want to be more politically correct and include an English speaking country. These countries share the dubious distinction of wallowing in the quagmire of debt to such an extreme level that they are all on the brink of insolvency!

But, we don’t need to look across the Atlantic to see the quagmire of debt! While most analyses of the current situation focuses on either the PIGS (as they are affectionately known) or the US mortgage crisis which has become an easy target, they miss the much larger view. Over the past 30 years, the most mature economies in the world have been piling up debt on debt! The growth of debt and leverage was of crisis proportions long before the punch bowl was removed two years ago. In 2008 when the market started to really worry about the debt buildup and started to cut up the credit cards, the Great Recession immediately commenced. The response from the public was appropriate, begin to de-leverage and unwind their debt. Unfortunately, governments after helping to stabilize the global financial system proceeded to re-leverage the world’s economy! The Great Recession kicked off the beginning of what has become the most significant level of government intervention we have seen since the 1930s. Governments around the globe stepped in to replace the “invisible hand of Adam Smith”. Finding it

easier to blame the debt problems on the free market rather than on its participants, governments have in the end made a bad situation worse.

In response to the debt crisis, central banks drove short-term interest rates to near zero percent. This manipulation of interest rates did nothing but further protect debtors who created the problem in the first place while penalizing savers or creditors. They also embarked on a systematic program of counterfeiting (economists with PhD’s call it quantitative easing, regular people like us who will have to pay the bill call it what it is, printing money) and massive deficits leading to escalating public debt levels. For a brief period of time, it seemed to some as though government balance sheets could absorb all the private sector’s debts and misdemeanors along with misguided stimulus packages. The markets rebounded, stocks began trading at normal P/Es, interest rates and spreads started to look more normal and GDP, representing the output of our economy, started growing again. The only apparent negative continues to be the employment picture which is dismal.

Unfortunately, there is one very serious problem with this current scenario. The problem is that governments are no different than you or I, they do not have the infinite capacity to leverage themselves. Creating more debt to get out of debt at a time when both the private and public sectors are severely intoxicated with debt is the height of folly. The current situation doesn’t even begin to factor in the aging of our populations throughout the developed world; nor, does it factor in the ludicrous entitlement promises

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in the form of pensions and healthcare that governments have put “off balance sheet” and do not have the capacity to pay in real dollars. The so-called government solution, with its bloated balance sheet and never ending entitlement promises to a rapidly aging population means, in essence, that most of our governments throughout the developed world are not only counterfeiting our paper currencies, but running history’s largest Ponzi schemes.

We’re all PIGS now! From a teetering Japan to South Korea, France, Germany the UK and the US they are all PIGS. But Canada you say, we are different! Surely, we can’t be placed in the same pen? The truth is we are far from the bottom of a bad bunch, but we are nevertheless on the same road and trending in the same direction. A quick glance at Ontario’s fiscal situation is enough to sober up any rational investor. Few Ontario residents seem to realize that our provincial government is currently running an annual deficit in excess of \$20 billion, or more than 4% of our provincial GDP (this is on top of our federal government that is running a deficit of over \$50 billion and more that 3% of GDP. This puts Ontario’s combined deficit over 7% of GDP). Our total debt in Ontario is north of \$200 billion. Only our neighbour to the east, that is Quebec with an outstanding debt of approximately \$300 billion, is larger! Former Bank of Canada Governor, David Dodge, recently pointed out that our deficit in Ontario which is now larger than any other province has become structural. We need dramatic leadership from Queens Park to cut the size of government or Ontario taxpayers will be saddled with an increasing debt burden, and greater taxes regardless of whether the economy rebounds or not. We must also allow for considerable infusions of private moneys into our underfunded and crumbling healthcare system. We cannot indebt ourselves further and remain

prosperous. It is shameful that Ontario is now receiving transfer payments from the rest of the country. It is even worse that Ontario is dependent on the largesse of the global bond market given our reckless issuance of debt. With our credit rating dropping and our debt piling up where are our leaders? Don’t forget that almost half of the Ontario budget goes towards our sacrosanct healthcare system that no one wants to pay for but everyone wants to use. Cleaning up our own mess will be very arduous and painful.

It’s easy to point fingers at the “lazy and corrupt” Greeks, the “lavish spenders” in Dubai and the “greedy” Americans but it’s much harder to look in the mirror at our own situation in Ontario and fess up to our own folly and short-termism.

Whether it’s Ontario or Canada or any other developed country in the world we cannot exit a debt crisis by “creating more debt”! As one commentary pointed out, 40% of the world’s GDP currently resides in countries that are running annual deficits in excess of 10% of their GDPs. That is an astounding statistic that underscores the vulnerability of the global economy. Sovereign debt has become the new sub-prime! Yes we are all PIGS!

Challenges Always Provide Opportunities!

Now that we have laid out a few of the challenges, let’s shift our attention to the opportunities and how we are going to manage through this mess on the equities side of our portfolios. There is no use ignoring it, ignorance is never bliss when it comes to investing! What types of businesses should we invest in? What sectors should we be focusing on? How can we protect and grow our capital? These are the questions that preoccupy us

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and our network of friends and contacts. Let me lay out the **top 8 items** we are looking for in the businesses we are investing in:

1. **Powerful franchise and reputation.** The greatest predictor of future revenue or sales for a company is anchored in the firm's reputation. We only invest in businesses that have strong reputations. In uncertain times people gravitate to what they know best and can trust.
2. **Balance sheet strength.** We will only invest in businesses that have fortress-like balance sheets and are prudent in how they use and structure the use of debt in their business. We want companies that generate excess cash and are not dependent on external financing. Given the debt crisis balance sheet, strength will continue to be a huge competitive advantage.
3. **High barriers of entry.** We invest in businesses that cannot be duplicated in the short to medium term.
4. **Essential and understandable business.** Given the tough economic environment we are in, and will remain in for some time, we need to make sure we are investing in businesses that have a high priority in consumer's spending routines! We want businesses with first or second call on consumer's wallets!
5. **Proven track record with a business model that produces consistently high returns on invested capital.** We are only interested in investing in businesses with models that have, in the past, produced strong margins and high returns on every dollar invested in the business. We are

not investing in unprofitable and unproven businesses that would be particularly vulnerable in an inflationary environment.

6. **Scarcity. The best business is one that solves a scarcity issue.** One only need consider the following industries: the water industry, agricultural industry, urban real estate and some healthcare and technology companies to find wonderful businesses that are unique and provide either an essential service or product that is in high demand and cannot be easily replicated by another company.
7. **Assets of the firm cannot be undermined by monetary folly.** The best assets are non-financial assets that cannot be printed by governments and their central banks! Any business whose value is not tied to the real economy and cannot re-price in the face of inflation is vulnerable to lower margins and an eroding capital value. Given the size of the debt problem, the pressure to continue printing money and devalue our paper currencies is very high.
8. **Management team eats its own cooking and is characterized by integrity.** We strongly prefer companies where the largest shareholders are the executives in the company and the reputation of management, for thinking long-term and in a shareholder friendly manner, is beyond doubt.

If we can find businesses that exemplify the majority of the foregoing items, and buy them at attractive prices, we believe very strongly that we will be able to weather the

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monetary and fiscal recklessness all around us. Companies that have these types of attributes should not only maintain your purchasing power, but they should be able to pay healthy and growing dividends and grow the total value of your investment in the years ahead. We also believe that it is important to have exposure to a number of different sectors providing a solid foundation of diversity and adding to the safety of investors' portfolios. We continue to invest across the following eight broad areas: financials, healthcare, commodities, real estate, infrastructure, industrial, consumer and technology.

Some of our top holdings currently include: xxx, xxx, xxx, xxx, xxx, xxx, xxx. From powerful retail banks, to oil and gas companies to leading global infrastructure investments, to generic drugs to food and water businesses, we own the best businesses we can find most global in scope. Our fundamental belief is that despite all the challenges facing the global economy, and there are many, essential businesses offering essential services run by competent business people will always be in demand. Consumers will still need banks. Consumers will continue to burn fossil fuels, and will still have to feed their bodies and drink clean water. Some will even be prescribed more drugs, generics of course, by their doctors! It's not more complicated than that! We live in a crazy and irresponsible world, but even crazy and irresponsible people need the essentials to live. Together, we own all the essentials!

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