

“I Owe, Therefore, I Am”

Investment Update

A. Introduction

The phrase cogito ergo sum, “I think, therefore I am”, is a Latin expression popularized by the 16th century French philosopher, Rene Descartes. The phrase is recorded in Descartes’ work *Discourse on the Method*, in which he attempts to arrive at a fundamental set of principles that one can know as true, without any doubt. In brief, Descartes argued that if he doubted, then something or someone must be doing the doubting and therefore the very fact that he doubted, proved his existence. Hence the expression, I think, therefore I am. For Descartes, existence was proved on the basis of a personal thinking “I”. While this is fascinating fodder for students and professors of philosophy, it’s probably not that interesting to the average person today. With a wee bit of cynicism in mind, I suggest that if Descartes were alive today his task would be much easier than in 1637, when he coined the cogito ergo sum phrase. All he need say today is, “I owe, therefore I am”.

In a world with more than USD \$200 trillion in outstanding debt instruments, well over USD \$150 trillion in unfunded liabilities and promises (social welfare schemes) and over USD \$700 trillion in unregulated over the counter derivatives, and each compounding higher, it’s not difficult to see that the essence of existence today is to be in debt. Whether we like it or not, we are all in debt. The dishonest foundation upon which our financial system is built coupled with the profligacy and blatant corruption of virtually every national government around the world has created a literal debt tsunami. Even those of us who have spurned the use of debt, have paid our bills on

time, and in cash, have become tethered to this global debt nightmare. Bottom line: we are all debt serfs of the State. The ontological statement of the day really has become “I owe, therefore I am”!

Lest you believe Canada is not faced with severe debt problems, let me remind you that both Ontario and Quebec are burdened with levels of indebtedness that are some of the worst in the world. We are facing a bleak future in Ontario, unless we immediately cut the size of the provincial bureaucracy. Ontario residents bear a provincial debt load equal to 40% of Ontario’s GDP. When combined with our federal debt, our total debt to GDP ratio in Ontario is approximately 80%. (In neighboring Quebec, their total debt to GDP ratio is approaching 100%.) At a time when the global economy is on the verge of a great depression, and the developed world is faced with unprecedented demographic challenges, it is not a time for more debt and misguided government intrusion and manipulation in the economy.

One other point to consider pertains to the IMF (International Monetary Fund). Every time the IMF opens its pocket book, we are on the proverbial hook as a funder of this “eminent” organization. Canada’s portion of the IMF’s largesse is currently 2.68%. So when the IMF prances around and commits to supporting the bankrupt and insolvent European Union, please note that Canadians are going further into debt. For every \$1 trillion the IMF flings, we are supporting the recipients to the tune of \$26.8 billion! Isn’t it ironic that an organization set up

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to help “poor nations” is increasingly being pressured to bail out “rich” Western Europe? We truly live in historic days.

B. Finance Gone Mad

The most informative and thought provoking book I have read recently is “Currency Wars”, authored by James Rickards. In this text, Rickards highlights a number of the challenges facing the financial world over the next few years. These challenges emanate from our cultural short-term greed and materialism coupled with our blind adherence to seriously flawed monetary and economic theories.

Rickards points out that in the late 1940s, economics increasingly separated itself from political science, philosophy and law (the arts) and sought new alliances with the hard sciences of applied mathematics and physics. Armed with their mathematical models and theories, economists became the new high priests of an ever increasing part of the world. This included the domains of wealth creation, employment levels, savings, capital investments, interest rates and all sorts of government policies. Economists held out the promise that through the fine-tuning of fiscal and monetary policies, the rebalancing of the terms of global trade and the spreading of risk through the use of complex derivatives, market fluctuations could be smoothed and economic growth rates extended beyond anything we had seen in the past. It all sounded so noble. And, we all took it in, hook, line and sinker! All we had to do was one “tiny” thing. Hand over much of our political and economic freedom to government and their central banks, so they could proceed to micro manage the economy and provide us with unlimited prosperity!

One of the core tenets of modern finance is that there was no need to maintain “hard money”

rooted in a collateral standard such as gold, despite five thousand years of history to the contrary. Economists posited that in this new era of manipulation and numbers they knew best and could be trusted. They would carefully provide all the money we needed to sustain the desired high levels of growth necessary to pay for all the wonderful government promises we could now afford. A little financial engineering here, and a little financial innovation there, would all work out for the benefit of everyone.

Another core tenet of modern finance is that we can isolate risk in a portfolio. The assumption is that we can reduce all of the variables of a dynamic economy down to a couple of formulas. What arrogance! This has led to the use and abuse of derivatives, which are touted as being able to perfectly allocate market risk, and mysteriously place them into the hands of the best people. Unfortunately, all the detailed and highly complex econometric models in the world have not advanced our ability to isolate and play with risk! If anything, our blind belief in risk tools such as derivatives along with our faith in our ability to isolate risk has encouraged more leverage, more speculation and more complexity. Our economic and financial pedagogues have failed us.

The result of this massive outsourcing of thought and responsibility to the government, economists and financiers has been a disaster that will fill the history books, for the next millennium.

Today, our monetary system is not rooted in principles of hard money or sound money. Without a collateral standard, our monetary unit has become an instrument of pure manipulation. Our money today is built on the adeptness of our central bankers to propagandize the masses and issue and contract paper currency at will.

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The fiscal policies of our government largely beholden to what many refer to a Keynesian view of the world, still holds to the mythology of the multiplier effect. Simply stated, as the government spends a dollar, more than a dollar in economic activity is created. Unfortunately, the reality today is that a dollar of government money spent leads to less economic output, and a contracting of the economy. This should not surprise anyone. As government expands, we place more of the economy is in the hands of the most inefficient and wasteful sector. How could this multiple anything but sorrow? Yet, governments continue taxing and spending, all the time shrinking the most productive parts of our economy, and taking savings away from the most industrious people.

Financial economics and investment management as practiced today is comparable to a man trying to climb a ladder made of water in the middle of a bottomless ocean. Notions of efficient markets (the market is always right in its pricing of financial instruments), normal risk distribution curves, (for those of you who remember your university statistics courses), and other academic notions of diversification, risk and leverage show little to no relation to the real economy and the true behavior of capital markets. Most of the current finance curriculum taught to our students today is for practical purposes - deficient, and should be rewritten!

Andrew Haldane, of the Bank of England, in a recent speech provided some shocking figures. They reflect recent developments in finance and economics. Note the massive change in attitude towards debt. Bank assets, or loans, have skyrocketed over-time as the UK has become a nation of spenders not savers. Capital as a percentage of asset value has shrunk dramatically. The attitude is: who needs capital or savings when you can borrow, borrow and borrow, all backed by paper money? Although

Haldane references the UK, these numbers and the trends they represent are similar across most of the developed nations.

“In the 1880s, total UK bank assets were equal to 5% of GDP. At the bubble peak they were 500%. As to consolidation, the assets of the UK’s three biggest banks at the start of the 20th Century were 7% of GDP. By the end of it they were 75% and by 2007 - astonishingly - 200%. Leverage climbed from 3-4 times in the 19th Century to 30 times in the bubble. And return on equity - unsurprisingly - went from modest single figures to 30% at the peak.”

Much of our time during the past five plus decades has been spent leveraging up our economies with the use of financial engineering. Instead of investing in ways in which we could become more productive in the manufacturing of everything from capital goods and agricultural products to high technology products we have become debt junkies. Investments that should have been directed to main street have been sacrificed for investments in finance, debt, derivatives and paper assets that, in the end, have little to no lasting and meaningful value to our economy. Finance has gone mad!

In essence, the entire system of fiscal policy (government spending), monetary policy (adjusting interest rates and money supply), banking and risk management is intellectually dishonest and is built on presuppositions that are flawed. In the end, we have created a complex web of financial instruments, debt and promises that are so outrageous that very few people are prepared to challenge them. Why? It is too difficult to challenge a system that is beyond understanding. Most people find it is too hard to believe that “the experts” don’t have a clue what they are doing.

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The complexity of the current global financial system has grown too much and is now both unstable and unsustainable. It is essential that finance and economics be returned to their proper role as the providers of capital to the productive class, rather than, a distorted end in itself where capital is siphoned off to the speculator class, which includes national governments and worst of all transnational organizations such as the IMF.

C. Where we are Today and Where are we Headed?

In order to “simplify” the current state of affairs along with the probable trajectory we can expect to traverse, we have divided this section into seven steps, six of which are largely behind us. Remember the backdrop we are operating in; the outstanding global debt is beyond the capacity of the global economy to service. Stated bluntly, there isn’t a hope in Hades that the outstanding debt can be paid down in any meaningful and honest manner. With this in mind, let’s consider where we have been and where this is all headed.

1. The first step in the global debt crisis was to hold off deflation at all costs and keep the economy inflated. This meant that the first step was to print money otherwise known as “quantitative easing”. We discussed this euphemistic expression for monetary debasement in the fall of 2010 along with our critique. As we pointed out, printing money is analogous to administering drugs to an addict in withdrawal. Sure it eases the pain, but it does nothing to deal with the underlying problem, a drug/debt addiction. Printing money debases your currency, attempts to cover up bad debts, and passes the costs of financial folly to everyone through inflation, instead of holding the specific people responsible accountable for their actions.

The indebted world chose this path with glee.

2. Since the printing of money does nothing to deal with the systemic problem of too much debt and too much spending the challenges do not go away. They become worse. Rather than sound money being invested in long-term capital projects, in order to underpin the long-term productive capacity of the economy, governments and citizens continue to spend recklessly.
3. Central banks, the great monetary manipulators, not content with merely debasing the currency, turned their firepower to the manipulation of interest rates. As financial expert Jim Grant stated, the central banks have “nationalized” the yield curve by attempting to set and control all government borrowing costs. This includes both short-term and long-term rates (operation twist). We discussed in a previous newsletter the devastating impact of zero interest rate policies (ZIRP). In essence, government debt securities (bonds) become “certificates of confiscation” with inflation (propped up by loose monetary policies of the central banks) which is kept higher than the interest rate paid on government bonds. In other words, investors are guaranteed to lose money when they invest in government securities. This is correctly referred to as, financial repression.

With interest rates close to zero, too many investments today have become suboptimal and investors are very cautious about committing long-term capital, when they are not being adequately compensated for the risk they are taking. The problem is, no capital investments equals, no new wealth creation. But, it is wealth creation that we desperately need if we are to going to be

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able to service and pay down our debts and emerge with a healthier economy.

4. With interest rates at record lows, governments and their citizens continue to borrow, spend and consume, all to “help the economy”. But, it’s a sick economy that requires its participant to waste their economic resources in order to prop it up! Rather, we must be prepared to slash government spending, raise interest rates and incentivize consumers to become savers and investors again. It’s disturbing when economists, government officials and average people do not know the difference between debt and capital. Capital is the result of savings and profit and is best protected within an economic system of sound money. If sound money is compromised, as it has been today, investors will invest their capital directly into hard assets in order to protect their hard earned wealth. This can hinder our ability to grow the economy long-term. But, who can fault investors who want to protect themselves from such economic and monetary folly?
5. In the current environment, sovereign debt levels continue to escalate. One by one, particularly in Europe, national governments are having difficulty rolling over their massive debts. Finally, investors are selectively realizing that the Ponzi scheme known as government debt and deficits is up. Witness Greece, Portugal, Ireland, Italy, Spain, much of Eastern Europe, and soon to be virtually every European country. The dominos are falling fast.

These events are happening at the same time that the “too big to fail” banks are ready to fail again. National governments encouraged the “too big to fail” banks to load up on their overvalued debt! We discussed this corruption in a previous

newsletter along with the accounting fraud associated with the stuffing of government debt into the balance sheets of banks. The key point is that more and more governments cannot roll their debt at favourable rates, making them insolvent. Even Germany, the “paragon” of European financial strength, had a failed bond auction during the third week in November. It’s getting serious now.

6. Today, the private market is no longer very interested in buying much of the government debt and the financial institutions are out of capital. What now? The answer is simple: reality sinks in and interest rates escalate. Remember the easy money printing, the manipulation of interest rates and the continued escalation of debt? It all comes to an end! This should come as no surprise. The cocaine addict who repeatedly uses and abuses cocaine will suppress his myocardial contractility, reduce coronary blood flow and induce electrical abnormalities in the heart leading to a myocardial infarction and necrosis of his heart tissue. The monetary addict hooked on low interest rates, debasing of currency and compounding levels of debt will likewise end up in a state of monetary and economic necrosis.
7. The question today is: who buys all the debt (including both the deficits and rolling of existing debt)? The real answer is frightening. It is the buyer of last resort, the central banks. Where do the central banks get their money? Answer: quantitative easing, aka, quantitative oppression, or printing of money. When we reach this point the game is over! If the central bank (or the IMF) is the only game in town, the only buyer at the next auction the result can only be inflationary. If the central banks decide not to print money, we will witness unprecedented deflation and a

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banking collapse. In either case the prospects are not appetizing!

D. Moving Forward

There is an expression that is apropos today; the best offensive is a good defense. In brief, we are playing aggressive defense! Warren Buffet often quips that there are only two rules in investing. Rule number 1: don't lose your capital! Rule number 2: go back to rule number 1. These two rules remain the focus of our investing today.

We are determined to protect your capital through the economic “squalls” ahead. As we have emphasized many times before, we cannot isolate you from market volatility and the price swings that inevitably occur in the short-term. What we attempt to do is avoid permanent loss of capital by investing in assets that should be able to navigate their way through the economic storms and grow the purchasing power of your wealth. Despite the challenges we have discussed in this newsletter, they are in no way a deterrent for us when it comes to investing. We remain optimistic that a conservative and disciplined approach to asset accumulation will provide our investors with the best opportunity to protect their capital from the madness of the current environment. Money hidden under a mattress, in the context of this quantitative easing world, is no answer.

There are essentially three basic elements to our portfolio creation today. They are: first, reject modern portfolio management theories as developed over the past 4-5 decades; second, protect your investments from bad counterparty risk and; third, ensure all your investments are collateralized with the highest quality assets possible. Let us elaborate on each briefly.

1. Reject Modern Portfolio Management Theory. Charlie Munger (Warren Buffett's

partner) had it perfectly correct when he stated that modern theories of money management are all “twaddle”. Much of modern portfolio management simply espouses massive diversification to the point that your investments simply become the market. We believe more than ever, one has to be focused when it comes to investing. Today, it is important to actually avoid large swaths of the market, given the global debt crisis. For example, with interest rates at some of the lowest levels in four centuries one would be foolish to build positions in long-term bonds, especially government bonds! Risk management goes well beyond diversification and starts with contrarian thinking!

2. One crucial element when it comes to investing is to consider who is on the other side of your trade. This is referred to as counterparty risk. Can you trust your counterparty? Do they have the resources to make good on their commitment? Modern financial theory (incorrectly) tells us that governments are the highest quality counterparties. While this is true for brief periods of time, it is seldom the case over time, due to the corrupting influence of power and central bankers. In the current environment, governments have become some of the worst counterparties. The idea that government securities are risk free, a concept taught in our university finance courses, comes straight out of fantasyland not reality. Government securities are in most instances the riskiest of investments. That is why we do not have any direct investments in China, Middle East, India, Russia and large parts of Europe, both Eastern and Western. When it comes to your investments, the quality of the counterparty is crucial and it keeps us out of many investments when we cannot trust the national governments or particular businesses and their managers.

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3. The last element of our investing is ensuring that all our investments are well collateralized. As each of you are aware, we break your portfolios into three types of asset classes: cash, fixed income and equities. The ratios in your portfolios will vary based on your individual circumstances.

(i) Cash - we continue to maintain higher than normal cash balances. The cash balances help to moderate volatility and allow us take advantage of opportunities as they arise. We expect that volatility will remain elevated for some time.

(ii) Fixed Income - given extremely low interest rates we continue to invest in bonds with less than 5 years in duration. In fact, most of the bonds we own have durations of less than two years. We also restrict our bond purchases to entities with very strong balance sheets and pristine collateral. When trouble ensues the only financial item that matters is the collateral in the business.

(iii) Equities - the most important asset class that we invest in is equities (and preferred shares). Ultimately, it is the carefully selected equities that will protect and grow your capital. When we evaluate the types of equities we want to own we are searching for assets that are characterized by scarcity, they must be essential or necessary assets with few substitutes and require work, capital and time to realize value. In other words, they are as insulated as possible from the debasement of currencies! The main industries of focus remain, precious metals (gold and silver), agriculture,

water, infrastructure, oil and gas, basic staples, and well collateralized, fee based financials.

The famous value investor, Benjamin Graham, once stated that the stock market is a voting machine in the short-term but a weighing machine in the long-term. We continue to look for companies that weigh more than the current stock market scales indicate. Our focus on collateral (balance sheets), counterparty risk and prudent portfolio management that concentrates on the finest assets should continue to prove out over time.

Contact Information

ROCKLINC INVESTMENT PARTNERS INC.

4200 South Service Road, Suite 102

Burlington, Ontario

L7L 4X5

Tel: 905-631-LINC (5462)

Fax: 905-333-9116

Jonathan Wellum

jwellum@rocklinc.com

Doretta Amaral

damaral@rocklinc.com

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