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Our Massive Leadership Deficit

Business Update

Commencing July 1, 2010 the Harmonized Sales Tax (HST) is coming into effective. In Ontario, the rate has been set at 13% which is equivalent to the existing 5% GST plus 8% PST. While the "harmonized" tax is not larger than the current GST and PST combined, the government in its wisdom has broadened the number of goods and services that will be fully taxed. Although it is hard to believe, the new 13% HST will be applied to all investment management services, financial planning and administrative services related to trust and custodial services. In effect, this means that our investment management fees will now be taxed at a rate of 13% instead of 5% starting July 1, 2010. You will see this new tax added to your fees at the end of September 2010.

It is truly a sad state of affairs when governments resort to taxing the savings of their citizens. At a time when we need more and more Canadians to save, the government turns around and taxes that pool of savings!

We will work harder to generate strong rates of return so that this tax has a minimal impact on your return.

Investment Update

Our Massive Leadership Deficit

Benjamin Franklin is attributed with the quote, "when the people find they can vote themselves money; that will herald the end of the republic." Let us add to this quote, "the end of the republic is hastened when leaders who care only about their power, gladly accommodate the masses by making outlandish promises and racking up debt that can never be honestly repaid." Over the past weekend, we all had expensive ringside tickets to one of the largest displays of leadership deficit ever. We are referring to the leaders of the G8 and G20 nations! While these leaders preside over the largest build up of debt the world has ever seen, they offered no concrete solutions and took no responsibility for the problems. Worse, we Canadians had to borrow an extra $1 billion to pay for this circus. Oh yes, they did huff and puff about how they are going to cut the current deficits in half by 2013 and get to "sustainable deficits by 2016". They looked very sincere as they stood shoulder to shoulder and pounded their chests, telling us how they are, with great wisdom, solving all the financial problems never to be repeated again!

But who believes these discredited leaders? Why do we continue to listen to their twaddle? With deficits out of control and running at over 10% of GDP in many of the G20 countries, cutting them by 50% in three years is woefully inadequate and talking about sustainable deficits in 2016 is a cruel joke. Most of the G20 nations are already financially broken and face devastating demographics that require not only zero deficits today, but a cutting of existing debt and a right sizing (known as downsizing) of their economies.

Overall, the pledges made at the G8 and G20 were the standard fare for such meetings and the financial goals of deficit reduction are too little, too late. Governments need to slash their deficits, take hack saws to their accumulated debts and dramatically shrink in size immediately. Any turnaround in our economies requires less government and more disciplined capital allocation, based on a dramatic rise in savings. This can only be meditated through the strengthening of the private sector. It will never develop by printing more money and accumulating more debt. Government has become the problem.

Will our citizens ever realize that our governments do not create jobs or wealth? The current G8 and G20 policies will continue to weaken job creation and undermine our wealth by submerging it in debt. Every new dollar of debt simply weakens the value of our existing capital pool by increasing the leverage in our economy. Continuing to add to our debt in order to solve our debt crisis is ludicrous. All of us who are investors and owners of capital should be incensed. While this attack on wealth rages, very little money is going into new capital investments which must be the starting point for extricating ourselves from this economic mess.

A recent report released by the Bank for International Settlements states, "when the transatlantic financial crisis began nearly three years ago, policymakers responded with emergency room treatment and strong medicine: large doses of direct support to the financial system, low interest rates, vastly expanded central bank balance sheets and massive fiscal stimulus. But, such powerful measures have strong side effects and their dangers are beginning to become apparent."

The report details some of these dangers which include delaying the needed downward adjustments to the prices of assets and creating "zombie financial and non-financial firms." The artificially low interest rates are not helping since they are discouraging people from reducing their leverage and continuing to cause dangerous distortions in the financial system.

The report ends by stating, "although private sector debt has started to decline, public debt has taken its place, with sovereign fiscal positions already on an unsustainable path in a number of countries. In short, macro-economic policy is in a **vastly worse position** than it was three years ago, with little capacity to combat a new crisis – it will be difficult to find a source of further treatment should another emergency arise. Regaining the ability to react to economic and financial crises, by putting policies onto sustainable paths, is therefore, a priority for macroeconomic policy." But, where are the sustainable paths? Where are our leaders in crafting honest long-term plans?

Most of the governments in the developed world including those of the US, Japan, UK and the euro-zone region have made promises to provide entitlements (pensions and healthcare) to their citizens and to repay their bond holders that simply stated, cannot be repaid. This is obvious to anyone with basic computational skills. Our current crop of leaders, who just finished meeting in Toronto, continued to make promises and commitments that cannot and will not be kept. The force feeding of debt into our economies must be stopped immediately. If we do not stop, and in many ways we are already too far along, there will be a severe re-pricing of all financial assets with most dropping substantially. The assault on the current owners of wealth in the world by the "easy money, print more money G20" is nothing short of global theft, we should be outraged by these acts of financial dissipation.

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The government of Japan, formerly the second largest economy in the world, for example, has amassed liabilities to their creditors that are now over 225 percent of their annual gross domestic product (GDP) and this does not include their massive entitlement programs. All this on the backs of an aging population which will see the demise of 70% of their workforce over the next 40 years! The world's largest economy, the US, will in the next 12-18 months, despite President Obama's cutting the deficit oratory, watch their liabilities to bondholders exceed 100% of their GDP, but when the massive "unfunded" entitlement promises (social security and Medicare / Medicaid) are included the debt will exceed 500% of GDP. Putting aside the famous PIIGS governments (Portugal, Italy, Ireland, Greece and Spain) that will see both economic and societal collapse over the next decade, the strongest and most powerful European nations of Germany and France have total liabilities (on and off balance sheet) exceeding 400% of GDP!

The developed world has literally become a debtocracy, economies built on debt, debt and more debt. This gross under collateralization, justified by modern economic theory shored up by cowardly leaders, supported by voters bribed with their own money and enticed by the allurement of the social welfare state all built on watered down fiat currency, is passing away and we need to be prepared as best as possible.

Facing the Future Directly at RockLinc

Despite the current challenges, we remain cautiously optimistic. Our task is to allocate capital in light of reality and turn the challenges into opportunities. We will continue to take a medium to longer term view and invest in businesses that operate in essential industries, with pricing power, scarce assets and with irreplaceable franchises. In our last report, we discussed briefly our position in the Canadian Oil Sands Trust. Since the time of writing that report, the situation with BP and the problems with their Deepwater Horizon oil spill in the Gulf of Mexico has emerged. This tragic situation highlights the higher value that should be placed on terrestrial based oil and gas reserves. The Canadian Oil Sands Trust will remain a significant investment for our investors. We believe that the oil sands will continue to become increasingly important in meeting the energy demands of the global economy. The current quarterly dividend of $0.50, which generates an annual dividend yield of more than 7%, is also a healthy reason to own the stock.

Birchcliff Energy Ltd.

Another important investment that is owned by virtually all of our investors is Birchcliff Energy Ltd. While we typically do not invest in smaller capitalization businesses (market cap currently around $1.3 billion), Birchcliff is not a typical company. The firm is a play on the rapidly growing natural gas production in the Montney/Doig unconventional shale formation in northwest Alberta. Note the following: first, the Montney/Doig area is one of the richest natural gas discoveries in North America; second, the costs of extraction are very low which places a high value on the firms massive and growing reserve base; third, Birchcliff has a substantial and very valuable land bank. By some accounts, the land value of Birchcliff alone, given the area in which it operates, supports the current price per share of approximately $10.00. When both land and energy reserves are added together, the value of Birchcliff should exceed $20.00 per share. Depending on the price of natural gas, the stock could be worth more than $30.00 per share. In any event, we believe that Birchcliff is a wonderful asset with substantial upside over the next year or two despite the existing economic challenges. One other important point is that the company's largest shareholder (approximately 26% of the firm) is legendary oil and gas investor, Seymour Schulich. In the event of a takeover of the company by a larger firm, Mr. Schulich has a reputation for extracting top value for the shareholders of the target company!

Gold

We want to discuss very briefly our thoughts concerning gold. It was only 16 months ago that we started building positions in several gold companies. While we are not gold bugs, we are concerned with the monetary policies of our major central banks and the irresponsible fiscal policies of our governments around the world. We are not alone. Amid the global crisis of confidence, investors seem to be re-discovering the fact that gold has been used as money for thousands of years. As financier, J.P. Morgan once stated, "Gold and silver are money. Everything else is credit." Although gold is often portrayed as the investment of doomsday prophets, pessimists, and fear mongers, what is often overlooked is that gold, which has a history dating back thousands of years, is an excellent way to build in some insurance to your portfolio. In fact, the first reference to gold is found in Genesis 2: 11-12 where it is noted within the creation account in the Bible that there is a specific area known for its gold supply. In Genesis 13:2, we are told that Abraham was very rich in cattle, in silver, and in gold. Early on in history, gold was seen as an important store of value.

Charles de Gaulle summarizes our view on the subject when he stated, "Betting against gold is the same as betting on governments. He who bets on governments and government money bets against 6,000 years of recorded human history." The simple reason we have invested in gold is that we simply do not have any confidence in the governments around the world. High debts, escalating entitlement promises, aging populations and increasing money supply all point in one direction, the undermining of paper currencies. In light of this reality one's only protection is to first, buy precious metals such as gold and silver and second, invest in businesses with strong balance sheets supported by hard assets. When we refer to hard assets we include assets such as, real estate, infrastructure and commodities. While it is doubtful that we will build massive positions in gold we do believe it is important to have a significant weighting in gold in order to store and protect existing wealth from the ravages of debt and government profligacy.

Let us leave you with a quote from Alan Greenspan, former head of the Federal Reserve Bank, from an essay he authored in 1966 entitled, "Gold and Economic Freedom." Greenspan obviously wrote this long before he compromised his views while Federal Reserve Governor. As head of the Fed, he devalued the US currency through easy money policies that contributed substantially to the financial mess we are experiencing. Greenspan wrote, "In the absence of the gold standard, there is no way to protect savings from confiscation through inflation. There is no store of value." Today's paper currencies have been seriously weakened and continue to lose purchasing power. In light of this the best currency, in fact the only triple A currency is probably gold. We like triple A investments!

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In summary, expect the bad news to continue! But with bad news comes opportunities. You will be glad to read that we are not wearing rose coloured glasses. The best course of action, which we are following in your accounts, is to keep some cash handy, have a portion of your investments in high quality short-term bonds and the rest in well collateralized equities. It is important to keep your debt levels low with a plan to eliminate most debt as soon as it is feasible and consistent with your medium to long-term plans. Wisdom, discipline and understanding will keep us on the best path as we move ahead.

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