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Accounting Chicanery

Thomas Jefferson, 1816: “We must make our election between economy and liberty, or profusion and servitude. If we run into such debts as that we must be taxed in our meat and in our drink, in our necessities and our comforts, in our labors and our amusements, ... our people ... must come to labor sixteen hours in the twenty-four, give our earnings of fifteen of these to the government, ... have no time to think, no means of calling our mis-managers to account; but be glad to obtain sustenance by hiring ourselves out to rivet their chains on the necks of our fellow-sufferers ... and this is the tendency of all human governments ... till the bulk of society is reduced to be mere automatons of misery ... And the forehorse of this frightful team is public debt. Taxation follows that, and in its train wretchedness and oppression.”

Investment Update

Since the founding of ROCKLINC in January of 2010, we have focused on what we believe are the most important challenges facing investors and how to turn these challenges into investment opportunities. As we have emphasized repeatedly, the number one issue is the global debt crisis which continues to escalate in severity.

In previous newsletters, we have tackled a number of issues. A handful of these issues can be summarized as follows:

1. The largest economies within the developed world are insolvent. This means that for these economies to continue on their current course, they must issue new debt in order to roll over their maturing debt! On top of this, they must also issue new debt to fund current budget deficits and meet their rapidly increasing entitlement promises. When the private sector borrows from one party to pay off another, this is referred to as a Ponzi scheme. When the government engages in this practice of perpetual and increasing levels of debt, economists refer to this as “expansionary fiscal policy”. We are not fooled by this madness.
2. Quantitative Easing, which we affectionately refer to as Quantitative Oppression (printing excess money or watering down the money supply), will not solve our debt problems. Over time, it will make them much worse, (by inflating prices through currency debasement, not dealing with the systematic debt issues and rewarding reckless debtors) even if there is a postponement of the day of reckoning. As author and financial commentator Jim Grant recently pointed out, replacing the gold standard with the Ph.D. standard was a very bad trade!
3. Economic and monetary theory as practiced today and over the past six to seven decades (post Bretton Woods, 1944) is seriously flawed. A productive and prosperous economy cannot be founded on a leveraged financial system with very little equity. Nor, can it be built on the basis of large and intrusive

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governments. And, it can never be built on the backs of entitled populations who are content to use the tax system to pilfer from their neighbors, under the guise of social justice and fairness which are euphemisms for theft and laziness.

4. We are bereft of true leadership throughout our developed world. Character, courage, and truth are in short supply when it comes to our leaders. Taking the broad road, which is paved with consensus thinking, is much easier than taking the narrow road with less traffic and dealing with our difficulties as soon as possible. Refusing to deal with the current financial problems by attempting to solve a debt problem with more debt in order to “kick the can down the road” for someone else to deal with is an abdication of leadership.
5. Governments have become too large and are completely untrustworthy. We must approach their policies, which are focused more on their self-interest, rather than solving the problems, with the highest degree of caution and skepticism. When citizens can no longer trust their monetary unit (currency) to maintain its purchasing power and interest rates are manipulated to levels less than the inflation rate, (a form of financial repression), it’s time to protect yourself and where possible change the current policies.

Truth in Accounting?

One of the most important elements of a free market economy is the integrity of the accounting system. For an economic system to function optimally and fairly for all stakeholders, each person must be confident that there is truth in the numbers being presented. This applies to both the private

and public sectors. When it comes to the private sector, one only has to think about a company such as Bre-X Minerals which turned out to be one of the largest mining frauds in the history of the world. The company’s geologist “salted” their gold discoveries in order to inflate the value of their estimated reserves. This false reporting led to disastrous consequences for investors who relied on the financial numbers and reports coming from the company. How about Enron, the company with the “smartest people” in the room, and viewed as one of America’s most innovative companies for over a decade? Their financial numbers were as bogus as an eight-hour workday in Greece! They “created” one of the most valuable businesses in the world, by overstating their revenues and under reporting their expenses. Unfortunately, the numbers were a lie. When the truth eventually emerged the company immediately became insolvent and quickly declared bankruptcy.

In each case there was a massive misallocation of capital that destroyed significant amounts of wealth and inflicted untold hurt on investors who relied on the accounting numbers emanating from these firms. The importance of consistent and accurate record keeping cannot be overstated. Wise long-term decisions cannot be made without accurate and timely information. This is why it is essential that we have a transparent and honest legal system to ensure proper standards of accounting and to punish those that manipulate their numbers in order to obfuscate the truth for their advantage.

Today, we are faced with a substantial accounting problem that makes the Bre-X and Enron issues trivial by comparison. What happens when the government (which now represents 40% plus of the economy in most

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developed nations) is thoroughly dishonest when accounting for their financial condition? What happens when the regulators and central banks, entities that are supposed to be ensuring fair and accurate numbers, can no longer be trusted because they are using different accounting standards for their books and records? The short answer is, we have an enormous problem. Under these conditions, investors and taxpayers must take notice quickly and act, or risk losing their capital! Let us illustrate our point with two significant examples: the European Central Bank and the US Treasury. Please note that there are a plethora of other examples to prove our point.

1. European Central Bank (ECB)

The true role of the ECB in the ongoing Eurozone financial crisis is not well known by most people including investors. In combination with two other political entities, the IMF (International Monetary Fund) and the EU (European Union), the ECB has been involved in a huge “bailout operation” throughout Europe and in the process has leveraged its balance sheet to ridiculous levels. How have they managed to do this? First, they have provided cheap credit/loans to many of the weakest banks in Europe who are drowning in bad loans and poor credits within the Eurozone. The problem is much of this cheap credit the ECB has provided the European Banks, and has now put on its balance sheet, has a very low likelihood of ever being paid back at par. Worse, the “haircuts” on the loans will be substantial. Second, the ECB has helped to keep the weakest Eurozone governments on life support by purchasing significant amounts of their debt, at inflated prices and as the buyer of last resort. The rationale for buying these “future defaults” is pure and simple; to manipulate the interest rates lower in order to keep the borrowing costs of these

countries artificially low. But, this solves nothing! The real problem is that the debt in these countries is already too large, and even with lower interest rates, *can never be paid back in full*. Extending the terms and providing more debt is simply burying these countries deeper into a debt prison.

The losses, which the ECB has racked up by trying to bail out both banks and weak nations in the EU, look enormous. Let’s take a quick peak! Estimates show that the ECB’s direct exposure to the struggling Eurozone economies, the PIIGS (Portugal, Ireland, Italy, Greece and Spain), is approximately €450bn. Although not all these assets and loans are ‘bad’, many of them are trading at steep discounts in the market, which is anticipating significant losses for current holders. With the ECB leveraged around 25 times (for every €1 in capital they have €25 in liabilities), and with only €82bn in capital and reserves, it will not take too many write-downs to wipe out the entire capital base of the ECB. In fact, an *honest accounting* for the Greece financial situation alone, wipes out almost all of their capital rendering the ECB insolvent and placing them in the same position as Greece!

In terms of Greece, conservative estimates show that the ECB has taken on around €190bn in Greek assets by propping up the Greek state and Greek banks. If Greece restructures its debt (which it must do, regardless of what the politicians continue to say), the ECB will face losses of between €60bn and €80bn on the government bonds it has already purchased and on the collateral it is holding from Greek banks. Remember that the capital base of the ECB is approximately €82 bn. This is why the ECB does not want to write-down their holdings of Greek debt. Honesty in accounting for the problem would display the fact that the ECB is in need of a bailout. (The same financial analysis would

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also apply to the Federal Reserve, but that is for a future newsletter.) Of course, the ECB saying it isn't so, does not make it so, and that is why at ROCKLINC we are investing based on reality and not their accounting fantasy.

This is also one reason why we do not own any European Banks and are very concerned with the health of all financial institutions. The banks in Europe have been instructed by the ECB that they do not need to write down any sovereign debt they own, outside of their trading books, despite some of that debt trading at 25 - 50% discounts in the real market. During the so-called stress tests on the European Banks that were conducted last summer, the ECB allowed the banks to overstate the value of their exposures to sovereign debt, despite the inevitable risk of default for some of the debt. In effect, the ECB told the banks to simply "pretend" that all this bad debt would be paid back in full. As we reported at the time, this was utter nonsense, and time has proven our claim 100% accurate. Many of the European nations must default and significantly reduce the total value of debt owed. Extending the debt is not a long-term solution! It is unbelievable that these government bureaucrats continue to play investors and their citizens as fools.

What happens when the ECB takes into account the losses on their Irish and Portuguese debt along with the many non-Greek banks they are propping up? What happens when the Spanish, Italian and French banks, just to kick the party off, start to mark their "never to perform" loans to market? What about all the derivative products that no one knows how to value and how they will react in the face of debt defaults? The bottom line is that the ECB has trapped themselves into a world of lies, spin and accounting chicanery. Where is the truth in

their numbers? Does anyone care? Let me assure you as our client, we care and are investing your capital with this backdrop firmly etched in our mind. We must be prepared for serious defaults throughout Europe, there is simply no way out. The debt is too large and the equity is too small. The current level of equity can no longer service the debt. All the manipulation in Europe will not change this fact. Expect to see a lot of manipulation but, in the end, manipulation will only make the situation worse. Honest accounting anyone?

2. US Treasury

According to PIMCO's Bill Gross, one of the world's leading bond managers, when you add up all of the money owed by the US Treasury including the present value of the future liabilities embedded in all the entitlement programs the US is actually in worse financial shape numerically than Greece and the other debt-laden European countries! In total debt, the US is now the biggest debtor in the history of the world. This fact would horrify the founders of this great country who fought to create a country with limited government, low levels of public debt, minimal taxation and individual accountability.

While much of the public focus is on the US public debt, which is now approximately \$14.2 trillion, the government conveniently does not include all the unfunded liabilities they have guaranteed for Medicare, Medicaid and Social Security, which is close to \$50 trillion. Please note this is a present value calculation which means that the US government, if it were honest, should have \$50 trillion already set aside to fund these programs going forward. Since they have funded virtually none of these programs they are falling further behind each year by over \$2 trillion which shows up in none of their

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deficit numbers! When the government includes the other numerous debts and obligations related to the bailout of the financial system and the support of the housing market, the present value of the total debt and liabilities of the US Government approaches nearly \$100 trillion or 7 times their annual GDP. This is a staggering number, so large, that most people prefer to ignore the reality of the situation. Since the US Treasury uses its own accounting rules and reports its finances on a cash basis and not an accrual basis, they are able to get away with this fiction, at least for a while. The US is currently running an accrual deficit each year of over \$4 trillion. An accrual deficit includes the total increase in the value of obligations during the year, not just what has to be paid out in cash.

As we have pointed out in previous newsletters, the situation is much worse when you consider that the first group of baby boomers is now reaching the retirement age of 65. As the baby boomers begin to leave the nation's work force the problem of financing Social Security under the current regime becomes impossible. Despite the obvious, politicians continue to lie to their constituents who seem more interested in listening to lies rather than to the truth. The fact that Social Security has not been overhauled, displays utter contempt for truth and honesty on the part of the government. Let's take a moment to consider Social Security in the US.

Social Security is truly a fraudulent program that has been put on a pedestal for far too long. Over the years, it has gradually morphed from a program designed as a safety net to a pure welfare program. Despite the reality that the world has changed, spineless politicians have chosen not to change this program, putting millions of Americans at risk

of retiring in total poverty. When Social Security was created in 1935, an individual could begin to collect benefits at age 65. At the time, the average life expectancy was just 62 years so many Americans never collected any money from the system. Currently, Americans are expected to live until age 78, but get to retire at 67. It's accounting chicanery that lets people work an extra two years and gain fourteen years of subsidized living. It must be new economic math that allows 17% of the population to collect benefits with just three workers supporting every retiree compared to the 1940s, when just 1% received benefits that were being funded by more than forty workers per retiree. While the whole paradigm has changed, the politicians continue to lie and promise benefits that can never be paid under the conditions that exist today.

In the end, the Social Security welfare program serves as a dazzling example of original intentions gone awry. We could similarly look at other federal and state programs in the US, including Medicare and Medicaid, unemployment, and public pensions that exist under similar fiction. In each case, we would find grossly underfunded promises/liabilities, propped up by poor accounting standards and debt as far as the eye can see. (Lest we feel complacent here in Ontario, the fiction of universal health care and the sustainability of the current funding mechanism are just as fanciful.)

Our point is fairly simple. The government will in the very near future renege on most of their promises. When the largest entity in the economy, the government, cannot be trusted, given their duplicity and abrogation of their responsibility to provide and ensure honest weights and measures, it is essential that we protect our capital and even more

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importantly our personal freedom. As Jefferson pointed out in the quote that began this newsletter, unchecked debt leads to excessive taxation, which leads to oppression. This is the history of all indebted governments and their naïve citizens!

Investment Strategy – Protecting Our Capital

The situation today means that we must be vigilant in our assessment of risk and in the execution of our investment strategy. Despite all the challenges, we believe that if we keep focused on the right businesses, industries, and what we pay for these companies, we will be able to protect and grow your capital. The most important characteristics of the businesses we are investing in continue to be: 1) firms that are well-financed (strong balance sheet), 2) sell essential products or services, and 3) control and own scarce assets in safe countries that cannot be undermined or destroyed by easy monetary policies and currency debasement.

Sectors that form a key part of our investment strategy include, but are not limited to, oil and gas, real estate, agriculture, water, consumer staples, precious metals and infrastructure. In this newsletter we want to focus on one of these areas; infrastructure.

Infrastructure – Brookfield Infrastructure Partners L.P.

One sector of investment opportunity we have discussed since the founding of ROCKLINC is the area of global infrastructure. There is no question that investor interest in infrastructure has increased substantially in recent years. The combination of global population growth and economic expansion throughout the world has contributed to

spending increases on infrastructure. Current estimates indicate global infrastructure spending will average \$2 trillion annually through 2015, and that the long-term infrastructure gap that will have to be “bridged” is more than \$25 trillion looking out 20 years. This represents an incredible potential for private sector involvement. Given the indebted financial position of most local and national governments, more and more of the needed investment capital will have to come from the private sector.

There is also another reason we like infrastructure assets within the current environment. They represent hard or tangible assets that are less vulnerable to the current policies of our governments to pay for their debts by the systematic debasement of our currency. Most infrastructure businesses are able to negotiate long-term revenue contracts with substantial inflation protection which we expect will be more important in the months and years ahead.

One question many of our investors ask is: what is infrastructure? One concise definition is as follows: Infrastructure refers to the physical long-life assets that provide essential products or services for the global economy. These assets include transportation (toll roads, ports, bridges, airports, rail and tunnels), energy and utilities (electricity transmission and distribution networks, generation, oil and gas pipelines and storage, water and waste water), communications (wireless communication towers, broadcast satellites, cable networks) social (education facilities, healthcare projects) and other assets such as timber and industrial infrastructure.

Despite the sector being a wonderful area to invest, it is critical to invest in a firm with a

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competent and disciplined management team that knows how to take full advantage of the opportunities and avoid the problems. One of our largest holdings amongst our clients is Brookfield Infrastructure Partners (BIP). The firm is characterized by the following important attributes: proven track record, strong balance sheet, access to capital, high quality assets with substantial growth opportunities, pure-play infrastructure vehicle, and diversified exposure to both countries and asset types. The company also has a competitive advantage given their relationship with their parent company, Brookfield Asset Management, which owns approximately 30% of the firm.

BIP has to-date put together one of the highest quality pure-play infrastructure firms in the world. In particular, BIP has significant exposures to utilities - 43% (electricity transmission, energy distribution and coal handling), transport and energy - 41% (energy transmission, railroad and ports) and timber assets - 16%. Their asset footprint is not only broad in terms of the type of infrastructure assets they own, but they also have a substantial global footprint. Currently, 46% of their assets are in North America, 31% in Australia, 12% in Europe and 11% in South America. We also like their mix of revenue with 40% contractual, 37% regulated and 23% flexible, based on shorter-term market conditions. This provides our investors with a predictable cash flow and enables BIP to pay out to investors between 60 - 70% of its cash flow resulting in a terrific dividend yield in excess of 5%. They expect to grow their dividend between 3 - 5% annually for the foreseeable future. The performance of the business has been exceptional and, equally important to our investors, the price per share has climbed from approximately \$17.00 in January 2010 to a current price of \$24.50 with an annual dividend of \$1.24 per share.

We expect to be shareholders in this business for many years to come.

Summary

There are no shortages when it comes to challenges facing the global financial markets. We are frustrated by the increasing levels of debt, both in the public and the private sectors. We are disappointed by the lack of leadership in virtually all areas of the culture and economy. We are surprised by the increasing manipulation of our markets and financial information. Nevertheless, we enter into the markets each day with our eyes wide open looking for great opportunities to grow your capital. Although the world is an uncertain place, we will continue to bring long standing commonsense investment principles to our decision framework and attempt to minimize the impact of the uncertainty we all face. One area we believe operates as a partial hedge towards much of the financial uncertainty is the precious metals sector. We continue to hold between 12 - 15% in precious metals exposure for our clients. This includes top quality mining companies along with Sprott Asset Management one of the most focused asset management companies in the world. They currently have approximately two thirds of their investments in the precious metals space with the remainder focused on energy and agriculture. We are firmly convinced that any investor that does not have precious metals exposure is implicitly showing complete faith in the US Federal Reserve, US Treasury and the European Central Bank. We have no confidence in any of these institutions, their leaders nor their governing economic and monetary philosophies.

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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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