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"Mene, Mene, Tekel, Parsin"

Proverbs 22:3 "A prudent man sees danger and takes refuge, but the simple keep going and suffer for it."

Investment Update

A. Introduction

One of the most important historical books in the Old Testament is the book of Daniel. In the fifth chapter of Daniel we have recorded a very instructive historical narrative concerning Belshazzar the grandson of Nebuchadnezzar. Under Nebuchadnezzar's reign, Babylon became one of the greatest powers in history.

We are quickly introduced to Belshazzar while he is in the midst of throwing a wild party for 1,000 of his lords along with everyone else that was "a somebody" in Babylon. As the evening progressed, the party became a drunken orgy with all his wives and concubines present. If that were not bad enough, Belshazzar decided to blaspheme the God of Israel by drinking from gold vessels that had been stolen from Solomon's temple in Jerusalem. The Biblical text tells us that the king, with joyous spirit, went on to praise the gods of gold and silver, of bronze, iron, wood and stone, despite the inanimate and powerless nature of such objects.

While Belshazzar was praising the gods of materialism, without warning a hand appeared and wrote on the wall next to where Belshazzar was sitting. The Bible records this occurrence as follows in Daniel 5: 5-9;

"Suddenly the fingers of a human hand appeared and wrote on the plaster of the wall, near the lampstand in the royal palace. The king watched the hand as it wrote. His face turned pale and he was so frightened that his legs became weak and his knees were knocking. The king summoned the enchanters, astrologers and diviners. Then he said to these wise men of Babylon, "Whoever reads this writing and tells me what it means will be clothed in purple and have a gold chain placed around his neck, and he will be made the third highest ruler in the kingdom." Then all the king's wise men came in, but they could not read the writing or tell the king what it meant. So King Belshazzar became even more terrified and his face grew more pale. His nobles were baffled."

Eventually the Jewish prophet Daniel was called in to interpret the handwriting on the wall. Before Daniel provided the interpretation he rebuked the king for the following:

First, for not learning from history and, in particular, from the experience of his grandfather Nebuchadnezzar who proclaimed throughout Babylon that the Most High God of Israel was sovereign in all the affairs of the world. Nebuchadnezzar had made it clear to his family that the wealth and power he possessed was from God.

Second, Daniel made it clear that Belshazzar was arrogant, that he lacked all humility and that he had blasphemed God by drinking from goblets taken from Solomon's temple and using them in his drunken orgy.

Thirdly, Belshazzar committed idolatry by worshipping the false gods of gold and silver rather than the true and living God, who created all things.

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Daniel then proceeded to interpret the handwriting on the wall. The words on the wall were "Mene, Mene, Tekel, Parsin". The interpretation given by Daniel was **"God has numbered your kingdom, and finished it. You have been weighed in the balances, and found wanting. Your kingdom has been divided, and given to the Medes and Persians."**

Later that evening, while Belshazzar partied, his enemies were encamped around Babylon. He believed that Babylon was safe. After all, it is reported that Babylon had enough food stored for 20 years. They had plenty of water from the Euphrates River which bisected the city. Babylon was surrounded by a series of walls, some as high as 300 feet. There were guard towers, soldiers, and Belshazzar believed that the city was unconquerable! He thought his kingdom would go on for a long time. However, Darius (the leader of the Medes and Persians) the opposing general, at that very moment had his troops diverting the water of the Euphrates and when the water levels fell low enough his troops simply marched into the city, under the walls. In the midst of his drunken party, Belshazzar was slain and the great Babylon was toppled in a moment.

From this historical narrative comes the often heard expression, "the handwriting is on the wall." It is a powerful idiom that speaks to the inevitability of an event occurring. Most often, the "inevitable event" is a long time in the making, but when it does occur it usually proceeds quickly, catching most people unawares. At ROCKLINC, we see a powerful and poignant illustration of this point with the unfolding global debt crisis. The amassing of debt throughout the world on the personal, corporate and sovereign level is without historic precedent, yet few see what is clearly obvious to those who are prepared to ask basic questions, challenge existing economic and financial paradigms and stop listening to our delusional leaders. Their willful ignorance, not unlike Belshazzar of old, is going to cost our country and the global economy trillions of dollars and as well as untold human suffering. As Dr. Michael Burry (the subject of Michael Lewis' book "The Big Short") recently stated in a commencement address at UCLA, "when the entitled elect themselves the party accelerates and a brutal hangover is inevitable. **Mene, mene, tekel, parsin.**

B. Europe – Sovereign Debt & Financial Institutions Crisis

1. Introduction

At this point you are probably exhausted from listening and reading about the European debt crisis. David Einhorn, founder of Greenlight Capital, included the following diagram in one of his write-ups recently. It helps to explain why we are so frustrated with the inaction of European leaders. They continue to hold useless meetings, bury the EU further in debt, ignore the democratic wishes of their people and expand the reach of government power. In short, Europe is living in a dream world, abstracted from reality.

The bottom line is they have no easy or painless solutions to the debt crisis. All the options moving forward are ghastly. Amongst our political class, there is neither the intestinal fortitude nor philosophic underpinnings to usher in the long-term corrective actions necessary to downsize the public sector and restructure the outstanding debt. Government has simply become too large, complex, manipulative and immoral to even move in the right direction. In our desire to live beyond our means, steal from our neighbour through progressive tax schemes, and jettison personal responsibility we forgot the warning of Thomas Jefferson; *"A government big enough to give you everything you want, is strong enough to take everything you have."*

2. Europe is heading toward financial ruin.

As we have pointed out on numerous occasions, the debt problems in Europe are not simply related to Greece and Spain. They are systemic in nature and involve all the countries within the European Union. There is no question that the southern countries such as Greece, Spain, Portugal and Italy are in the worst shape, and must dramatically restructure their finances (code for default), but even Germany, the "powerhouse" of Europe, is on a trajectory that is utterly unsustainable.

Let's consider Germany for a moment. According to Axel Weber, the former president of the German Bundesbank, Germany is in fact sitting on a real debt to GDP ratio of well over 200% when unfunded government liabilities are included. According to a more objective source, the Cato Institute, Germany's unfunded liabilities alone are closer to 400% of GDP! Social welfare is wonderful until you have to pay for it! Note that these total debt and unfunded liabilities do not include the amount of money Germany is yet to spend on recapitalizing its banks, which on their own admission will be at least 150 billion Euros (5% of GDP). It also does not include many of the obligations they have taken on so far in order to bail out their southern European friends. But if Germany is on an unsustainable path and has a true on and off balance sheet debt to GDP ratio of approximately 500% how can they bail out the rest of Europe, which is far worse? The answer is unmistakable, they cannot. This is why the cost to insure German debt is now inching higher. An increasing number of investors are realizing that Germany is not without it's own risks and challenges and is far from risk free!

Consider one other crucial area for a moment. If you add up all the debt sitting on the balance sheets of the European Financial Institutions, it amounts to approximately 150% of Europe's total GDP! Note, that as a whole, the entire European banking system is leveraged at nearly 26 to 1. This means that a move of only 4% in the value of the assets and investments which financial institutions own on their balance sheets would wipe out all the capital in the European Financial Institutions. As we have pointed out in previous newsletters, we believe that the capital in European Financial Institutions has already been cleaned out and the asset values on their balance sheets have moved down a lot more than 4%!

Corrupt accounting practices that do not require the marking down of sovereign debt and other assets carried on balance sheet to their true market prices has allowed the banks to mask their insolvency and continue in business. This accounting fraud has made it more difficult for investors to understand how bad the balance sheets are of the financial businesses operating in Europe. On top of this there have been ongoing bank runs, of varying severity, throughout the peripheral EU countries. This includes Greece, Portugal, Spain and Italy. Make no mistake – the absolute worst-case scenario for the authorities is a bank run. It terrifies all involved because they can spiral out of control very quickly and force financial institutions to liquidate balance sheet assets to cover shortfalls and maintain financial ratios. The problem is with assets carried at prices well above market the banks are forced to realize substantial losses as they liquidate and for the first time in years they actually have to mark their assets to a more truthful number, market value. Bank runs are exposing the insolvency of many financial institutions in Europe. Is it any wonder that the European Central Bank decided to lower the collateral standards for the European Banks? After all, why should banks need collateral in a fiat currency system, where debt is money? In the face of

further bank runs, we expect the EU to put in place more significant capital controls in order to manage the flow of money into, out of, and within Europe.

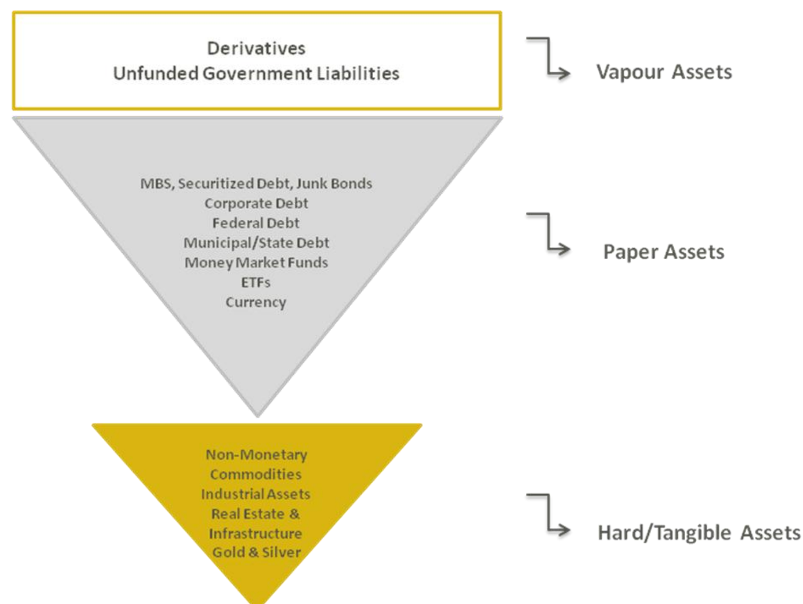
We do not own any European financial businesses. We believe that the equity value of all these institutions is zero and their so-called capital base, which is invested in the sovereign debt of European countries, is not real or tangible capital but debt, and overpriced debt to boot! We remain “old school” and believe that capital and solvency matter when investing in a bank or insurance company!

Just to make this financial gong show more farcical, on June 19th it was reported that the EU lawmakers were in the process of disregarding the findings of credit rating agencies and were going to be issuing their own sovereign credit ratings on their member countries. This is truly astonishing. But how can the same entities issuing debt also provide the credit ratings on that very same debt? This is only possible when you have the power to make up the rules and the truth is no longer palatable. But when truth is obfuscated it is time for investors to head for the exits as fast as possible. As Friedrich Nietzsche stated, “Sometimes people don’t want to hear the truth because they don’t want their illusions destroyed.” We have no illusions; the corruption in Europe has reached new highs.

The bottom line is that it no longer matters how you look at the situation. There is no way forward in which Europe can pay down, in any substantive and honest manner, their outstanding obligations. There is also no entity on earth than can bailout Europe. There are only two options left, either grotesque money printing (trillions of Euros) in an attempt to inflate the debt away or a deflationary collapse where asset prices collapse and we reset and restart our financial system. Neither is an appetizing prospect. We must be prepared. The handwriting is on the wall.

C. Inverted Pyramids & Taking Refuge

In order to visualize the current layout of assets we put together the following diagram to help you understand the current situation. It is important to note that the diagram is not to scale but does exhibit some proportionality, with the true size and risk profile of each grouping increasing as you move from the bottom to the top.



1. Hard/Tangible Assets

The strongest or most durable assets are in the bottom pyramid. These are referred to as hard or tangible assets. The most enduring tangible assets are monetary commodities such as physical gold and silver along with gold and silver mining companies. The other tangible assets in the lower pyramid include real estate, infrastructure assets (roads, railroads, pipelines, ports, electrical grids, etc.), industrial assets (manufacturing facilities) and finally non-monetary assets such as oil, gas, copper, nickel, agricultural commodities and water. Regardless of what happens with the financial system, these assets retain long-term value since they are both scarce and essential.

2. Paper Assets

The second inverted pyramid represents all the debt backed by individuals, corporations and governments. We have also included currency (which is backed only by government debt and promises) along with ETFs (electronically traded funds). The quality, durability and value of these debt instruments will vary significantly. Given the current financial woes, we prefer to have exposure to corporate debt backed by hard assets rather than government debt backed by hot air. Naturally, there are some governments that are more believable than others and if one has exposure to government obligations you must be very selective. In the next few years, given the unfolding nature of the debt crisis, the value of this pyramid in real terms must shrink dramatically. Whether inflationary policies erode the value of these obligations or whether a deflationary collapse wipes out a substantial portion of the debt, the debt must shrink as a percentage of the hard or tangible assets in the global economy. Our living beyond our means, and spending money we do not have and borrowing from the future is about to be significantly curtailed one way or another!

3. Vapour Assets

We refer to the top rectangle as vapour assets since these are the assets that we believe will be destroyed the quickest within the context of the ongoing financial crisis. They are also the largest in size. Consider for a moment the size of the derivatives market. It is reported to exceed USD $730 trillion and continues to expand rapidly. Warren Buffett has repeatedly referred to derivatives as “financial weapons of mass destruction.” Despite this warning, and many others, we continue to allow the expansion of these products without having a clue how they will perform in a state of crisis. I suggest, as we witnessed with Greece, when countries default or restructure, governments and regulators will attempt to neutralize the impact of derivatives by invalidating them.

The second component of what we refer to as vapour assets, are the unfunded liabilities of governments around the world. This includes all the social welfare promises that have been made over the past 5 decades and where no money has been set aside to make good on these promises. It is estimated that the total unfunded liabilities of governments globally exceeds USD $175 trillion or close to 3 times global GDP, which is estimated to be approximately USD $65 trillion. When one considers that the current level of global debt, that is traded, is now in excess of USD $210 trillion and add this number to the unfunded liabilities, you don’t have to be a rocket scientist to understand that there is not a hope in Hades that these government promises will be paid out; particularly, in light of the global financial debacle. We put little stock in the “vapour assets”. Expect the value of these assets to collapse first. Do not trust government blindly! Today, they are lying about what is happening; they are also lying about their ability to pay for the promises they continue to make.

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ROCKLINC's ABCD Strategy

I recently came across a strategy similar to the one we are deploying at ROCKLINC. The professional advocating this approach referred to it as the ABCD Strategy. The ABCD stood for "Anything Bernanke Cannot Destroy". In a nutshell, this captures the essence of how we are approaching the current environment. Invest in real or tangible assets; those that are scarce, essential and least encumbered by debt. The fundamental way to protect your money is to invest in assets that cannot be debased by reckless government policies, both monetary and fiscal in nature. Since we do not know the exact details of what will unfold in the weeks and months ahead, it is important to keep some investments in cash and short-term bonds in order to minimize volatility and have the firepower to buy assets in the face of market weakness.

1. Cash and Cash Equivalents

Over the past 8 months we have slowly allowed our cash and cash equivalent weightings to increase. Although we do not profess to be market timers and given the macro economic challenges, we have decided to keep some money on the sidelines in order to take advantage of market swings. We continue to use TD's deposit accounts as a safe place to park liquid assets and generate a small return.

2. Bonds

Focus on high quality yield from the strongest corporate bonds (largely non- cyclical industries, well capitalized with strong and liquid balance sheets). Given the low level of interest rates and the increasing pressure on yields, we are only adding bonds with maturities of less than 3 years. We are very concerned about a brewing bond bubble. Although we do own some provincial bonds, our preference is towards provinces with the lowest debt to GDP ratios. Based on this criterion, we are no longer investing in any Ontario debt and continue to avoid Quebec debt.

3. Equities & Preferred Shares

i. Focus on sustainable dividend growth and yield. This provides consistent cash flow into your portfolio for either reinvestment opportunities or supplemental income.

ii. Focus on sectors in the economy that are essential and scarce and backed by hard or tangible assets. Our focus is on the bottom pyramid in our diagram laying out the range of assets. It is this inverted pyramid that contains the assets that should maintain the greatest value and protect your purchasing power overtime.

iii. Overall, our clients have exposure to the following sectors: Canadian banking, oil and gas, real estate, infrastructure, agriculture, information technology, water, consumer staples and precious metals.

Independent, of whether the investment is in bonds or equities, we focus on businesses that have low leverage, significant liquid assets and transparent balance sheets.

As we have written about in earlier newsletters, we maintain significant positions in the highest quality gold and silver mining businesses. Along with oil and gas companies, these businesses have been poor performers over the past 9 months. We have, where appropriate, added to our positions in these businesses. Over time, these companies should provide a hedge or insurance against the implication of the global debt crisis. Regardless of the attacks on gold and silver as investments,

they have both operated as wonderful stores of value and protected investors from the money printing, currency devaluations, trade frictions between countries and confiscatory government policies for over 5,000 years.

We live in extraordinary days. Although they are not without some historic precedent, it does not mean we can protect ourselves completely from many of the challenges. Our objective is to think through the issues, try to keep our feet firmly placed in reality, learn from the past and invest for the future. We cannot take volatility out of your portfolio, but we can manage it and focus on medium to long-term preservation and growth of capital, which is more important and more attainable.

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