

## “Modern Tower of Babel”

### Investment Update

#### A. Introduction

What a start to 2012! During the first quarter, the Dow Jones Industrial Average was up 8%, the S&P 500 surged 12%, and the more relevant benchmark for most of our client assets, the TSX was up 4%. Overall, for the US markets, it was the best performance since 1998 which is a very odd comparison. You might recall that in 1998 we were at the beginning of the Internet revolution. It was also a period of fiscal stability with North American governments actually running budget surpluses! Interest rates were north of 5%, economies were experiencing sustained 4% real growth, the housing market was strong and properly priced, unemployment was sub-5%, and our central banks were not primarily in the business of manipulating the markets. So what’s going on?

Let’s take a brief look at the composition of the first quarter rally. Apple soared 48% and accounted for nearly 20% of the appreciation in the S&P 500. Apple now comprises 4% of the total S&P 500 market capitalization; and 11% of the NASDAQ market capitalization. Not since Microsoft in 1999 was one stock this dominant, though the valuations are not comparable (MSFT in 1999 was trading with a 70x P/E multiple and today Apple trades at a much more reasonable 15x P/E multiple).

But outside of Apple, what really led the rally in the first quarter were many of the lowest quality names, the same companies that were walloped last year. Let me provide you two examples. The first is Bank of America, which jumped 72%, after being the Dow’s worst

performer in 2011; in fact the financials in aggregate rose 22%. This occurred, despite the intensifying global debt crisis, and zero interest rate policy, on behalf of the Federal Reserve. The second example is Sears Holdings, which was shellacked in 2011 and despite not having a hope of a profit for the next several years, if ever, from its retail business, climbed 108%.

What does this tell us? It says that much of this advancing market is more about short-term moves and the chasing of excess liquidity pumped into the system by our central banks, than it is about long-term disciplined investing. When low quality stocks in the S&P 500 outperform high-quality stocks during the first quarter alone, by 5%, most market participants are acting and thinking short-term and not focusing on long-term values.

On a global scale, Japan, one of the worst places to invest over the past 22 years, became one of the best performers posting an amazing 19% advance in Q1, the best start in Japan since the pre-bubble-burst way back in 1988. Much of this advance is based on the increasing reality that the Bank of Japan will be forced to stimulate inflation by printing a massive amount of JPY (yens). Here’s a staggering statistic for you to ponder. With interest rates on government debt at only 1%, currently 40% of their tax revenue goes to paying the interest on their debt! If rates in Japan were to increase by only 2 percent, their interest expense would surpass their total expected tax revenue. This is transpiring within a country that is expiring to the tune of almost 1 million people per year,

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due to their aging demographic profile. With Japan beginning to run trade deficits, it's not hard to see that the Japanese debt party is coming to an end.

Even the favorite whipping boy of Europe, Greece rallied 7% in the first quarter, which is all you need to know about the quality of this rally. Meanwhile, we have real estate deflation rearing its ugly head in China, a UK recession, spreading European weakness (for all the talk of German strength, retail sales volumes sank 1.1% in February and have now contracted in four of the past five months), acute debt problems in Portugal and Spain that are going to erupt soon (there is already talk in Greece about the need for a third bailout), and U.S. data that has been coming out rather mixed despite the massive fiscal and monetary stimulus.

As you might have noticed, the stodgy sectors that worked well last year are biding their time, utilities/infrastructure so far in 2012 are down 3%, telecom is flat, staples are up a mere 5% and many of the leading energy and precious metals businesses were negative for the quarter and continue to get beaten down despite high commodity prices and the pressure to keep debasing paper money.

But, liquidity (money printing) is not an antidote for fundamentals. A market that lacks breadth, participation, volume and a strong economic foundation is not one you can rely on for sustained strength, notwithstanding the terrific first quarter that risky assets delivered. We have seen this movie many times before, and given the ending, we are opting to be very careful with your money. In fact, at the time of writing this report, the TSX has gone negative for the year and more "reality" is returning to the global markets.

**B. Modern Tower of Babel**

In the first book of the Bible, called Genesis, there is a very fascinating story found in chapter 11, concerning a very unique building project. The Biblical text tells us that at the time, after the historic flood, the whole earth had one language and began to settle in the land of Babylon. Rather than spread out and fill the earth, as instructed by God, the people decided to stay in one place and build the ultimate city. In the midst of the city they started to build a magnificent tower. The tower came to symbolize their independence, strength and pride. According to the text, the plan was to build the tower so high, it would reach into the heavens.

Unfortunately, this was not what God desired and this act of defiance did not go unnoticed. We read in the narrative that God put an end to their construction project by confusing their languages and thereby frustrating their ability to communicate with each other. The confusing of their languages led to the scattering of the people, across a wider geographic area. The partially complete tower became known as the "Tower of Babel", since this was the place where God confused man's language and brought their disobedient and pride filled plans to an abrupt end.

In a similar vein today, in what can only be stated as a total act of defiance against all economic, financial and monetary wisdom, we have been erecting our own version of the "Tower of Babel" which we will refer to as the "Tower of Debt". Financial history is littered with pompous politicians, ego driven economists, arrogant investment professionals and bankers along with a compliant media, that are quite happy to tell us, it is different this time. But nothing has changed, and the laws of mathematics and gravity have not been suspended, and as Rick Rule quipped, "when

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your outgo exceeds your income your upkeep becomes your downfall.”

As we have discussed in previous newsletters, over the past four decades the developed economies have gone on the biggest debt bender in history. The current level of global indebtedness, coupled with the massive unfunded government entitlement promises, is conservatively valued at over 6 times global GDP. Greece and the other Club Med countries are a mere warm up act, considering the financial insolvency of the European Union, United Kingdom, Japan and the U.S. Simply stated, none of these jurisdictions have a hope of ever paying down even a portion of their accumulated liabilities, without substantially debasing their money. They are each so strapped with debt and entitlement lies that none of them can currently service their interest, despite rates being close to zero, without borrowing more money or resorting to the printing press.

The problem should be clear, and the flooding of the financial markets with fiat currency only to “create inflation” will not fix a solvency crisis. Only morally insolvent central bankers with dilapidated spreadsheets and no real world knowledge could equate inflation with growth and continue to argue for more monetization of debt. Just as the original Tower of Babel was not completed, this 21<sup>st</sup> century construction, our own Tower of Debt, will abruptly end. The end will not be pretty and we must be prepared.

### C. Time to Stop Construction on Our Tower

There are three things I find stunning concerning our Tower of Debt. First, the short-termism of our policymakers is breathtaking. How can more debt, more money printing, more government, more manipulation of the markets and our

interest rates do anything but strangle private initiative and drive real capital and savings out of the economy? At the very moment we need more capital and savings to deleverage from this debt nightmare, we undermine the very formation of savings and investment. In fact, in many countries, governments are contemplating increasing the taxes on capital, the very item that needs to expand, not be assaulted by the politics of envy and greed. The second stunning aspect of all this is the willingness, nay desperation, on the part of the “market” and its participants to go along with policymakers knowing the increasing danger ahead. It’s just too easy to go along with the status quo rather than challenge it and attempt to change course. Lastly, it is astonishing to see how easily the concepts of democracy and the rule of law, two of the pillars of the western world, can be tossed aside and trampled on when politically expedient. This is particularly the case, in Europe where the citizens have not been allowed to vote on most of the extraordinary measures their “democratic” governments have been introducing. This we believe is a recipe for increased civil disobedience across Europe, particularly given youth unemployment rates (under 30 years of age) that are as high as 50% in many debt laden European countries.

There are four major components that comprise our GDP formula: government spending, consumption, investments and net exports. It is amazing that the one component, investments, that needs to be significantly increased is the very one that policymakers continue to emasculate! The bloated, inefficient and indebted government sector needs a dramatic downsizing. Citizens must assume a substantial portion of their own retirement, healthcare and education costs. Entitlements don’t just need an overhaul they need to be largely eliminated with only extreme exceptions. Consumption, which is approximately 70% of our GDP, must also shrink to a point that allows the private build up of savings to fund the level of

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investments necessary to ensure the long-term prosperity of our economy. It is only a capital rich, competitive and efficient economy that will be able to effectively compete in the global economy, enhance our export opportunities and grow real long-term jobs in our country.

The path our policy makers should be pursuing is to slowly increase interest rates, to reward saving and begin to put a real cost on money. Coincident with this must be an end to the reckless debasement of our paper currencies through so-called quantitative easing which only benefits in the short run, debtors and speculators -- the very ones that should be punished by subjecting them to competitive market forces. We need to immediately normalize the market mechanism and restore real non-manipulated prices so that wealth flows back into the hands of the frugal, enterprising, entrepreneurial and saving class where it belongs and away from the debtors, bankers and the public sector. Unfortunately, this course of action does not appear to be coming down the road anytime soon!

#### D. Resource Conversion - Opportunities

There are essentially two ways a company can create wealth for its investors. The first way is for the company to create a growing earnings stream, by selling more goods and services, and use that cash flow to expand its asset base, reduce its liabilities or distribute the excess monies to shareholders. Distributions to shareholders can be made through the payment of dividends, or the buying back of stock, which reduces the number of shares outstanding. This is typically the way most wealth is created by the companies in our portfolios.

The second way a company can create wealth for its shareholders is when the business goes through a “resource conversion”. A resource

conversion includes transactions such as mergers and acquisitions, changes in the control of the business, massive recapitalizations (restructuring of the balance sheet), and spinoffs.

#### Viterra Inc.

This takes us to one of our major holdings, Viterra Inc., who agreed to be purchased by Glencore International PLC, on March 19<sup>th</sup> for \$16.25 cash per share. This amounted to a 48 percent premium over Viterra’s closing price on March 8<sup>th</sup>, the day before it announced that it was in takeover talks.

We first heard of Viterra through a professional relationship we had with Third Avenue Management in New York back in 2006. At that time, the company was called the Saskatchewan Wheat Pool and was in the midst of a dramatic corporate restructuring. We carefully watched the transformation of the company and by 2008 were comfortable with adding the company to our separately managed accounts at AIC. When we formed ROCKLINC in January 2010, Viterra became one of our core companies.

In a nutshell, the company provided our investors with exposure to a premier Canadian based vertically integrated global agri-business. The firm has significant operations in Australia, United States and China. It was not a surprise that a larger company would eventually purchase the business. We expect the transaction to close around June and will redeploy the cash at that time.

It’s interesting to point out that despite the consistency of the business, and the strategic importance of the company, the volatility in the stock valuation over the past 27 months has been dramatic. In January 2010, the stock

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traded at approximately \$10.00 per share. By the summer of 2010, the stock dropped below \$7.00 and then finished 2010 at \$9.30. This volatility allowed us to purchase the stock for a number of our investors at very attractive prices. In 2011, the stock moved between a low of \$9.25 and a high of \$12.00. Prior to the announcement by the company that they were in takeover talks, the company was on very few “buy lists” and the stock price was meandering around \$10.00. We point this out to emphasize that those companies with attractive business models and tangible assets will eventually get priced “right”.

Since the formation of ROCKLINC in January 2010 this is the second company that has been acquired. The first was Nalco Holding Company, which was purchased by Ecolab Inc. and closed on November 30, 2011. Looking at our current list of top holdings there are a number of other companies that we expect will be takeover targets in the next few years. When companies are purchased outright a control premium must be paid and shareholders usually make a great deal of money.

**Birchcliff Energy Ltd.**

Another one of our holdings in our Canadian portfolios is Birchcliff Energy Ltd. The company is involved in the energy industry with approximately 75% exposure to natural gas and 25% exposure to oil in terms of their current revenue mix. We have held positions in this company for over four years and watched with great interest as the company has continued to grow its substantial oil and gas reserves. The stock price has reflected the good, bad and downright ugly despite a business characterized by great leadership and an expanding asset base. From the depths of the credit crisis in 2008 to the current share price we have lived through swings from \$3.30 to over \$15.00 per share. Currently the stock trades at

approximately \$6.50.

In the fall of 2011, the company was put up for sale after receiving a number of unsolicited offers from several international companies. Since that time, natural gas prices have dropped to levels not seen since the mid-1990's. With natural gas prices this low, it no longer makes any sense to sell the company and the firm announced an end to the sale process on March 29, 2012. Short-term investors were not pleased and pummeled the shares providing opportunity for long-term investors.

Birchcliff's Board has made the right decision by strengthening its balance sheet (issuing shares) and focusing on profitably growing the company. The company is controlled by billionaire investor Seymour Schulich (approximately 30%). Mr. Schulich purchased approximately a third of the latest issue at \$7.65 and subsequently purchased another 2 million shares (under \$7.00) demonstrating his long-term commitment in the firm.

We like Birchcliff Energy for the following reasons:

1. Excellent management team
2. Massive and growing oil and natural gas reserves
3. Safe country - all in Western Canada
4. Strong balance sheet
5. Low cost producer - can survive low natural gas prices
6. Attractive takeover company when natural gas prices revert to more normal levels

As is often the case in business, patience and discipline are some of the most important attributes. Birchcliff has massive oil and gas

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reserves that will only continue to grow as the company now focuses on exploration and development rather than a corporate sale. This decision to step back and build the business will further enhance the long-term value of the company. We will continue to carefully add to positions in your portfolios as appropriate. The significant drop in the share price is, in our view, overdone, and provides another wonderful point to add to holdings. We expect this company to produce substantial profits for investors in the next few years. As one of the best long-term investors we know recently stated “you need a real sense of humour to invest in a natural gas business.” Investing in a great company in a long-term growth industry when everyone is heading for the exits is usually the best time to be accumulating!

### E. Protecting and Growing Your Investments

Given the environment we face our number one objective is to protect your capital and attempt to grow the real value (after inflation) of your investments. If anything is predictable in this market it is volatility! Although most investors shy away from price moves, it is important to “use volatility to your advantage or you will be used by volatility.”

The situation we face is anything but “normal.” When the world’s leading economy, the US, is said to be in “recovery” when it is running a budget deficit of \$3.7 billion per day, an annual deficit of \$1.35 trillion, and expects to add \$5 trillion and \$10 trillion in tradable debt in the next 3 and 6 years something is very wrong! This tower will not be completed! When you factor in all of the on balance sheet and off balance sheet liabilities of the US, their total debt is now larger than Greece and exceeds 900 percent of their annual GDP! **Don’t let the magnitude of this number, and complacency of our “leaders” numb you from the reality.**

The situation we find ourselves in simply means that we must be vigilant in our assessment of risk and in the execution of our investment strategy. Despite the challenges, if we stay focused on the strongest companies, operating in the best industries and buy them at compelling prices we should not only maintain your purchasing power but increase the capital value of your portfolio. This will not occur without volatility in the value of your investments. We have provided a very brief outline of how we continue to approach each of the major asset classes.

#### 1. Bonds

Focus on high quality yield from the strongest corporate bonds (largely non-cyclical industries, well capitalized and liquid balance sheets with minimal refinancing needs). Given the low level of interest rates, we continue to focus on bonds with maturities of less than 4 years. We are very concerned about a brewing bond bubble, particularly, in the face of the competitive devaluation of the world’s major reserve currencies (Japanese Yen, US Dollars, Pound Sterling and Euro Dollars).

#### 2. Preferred Shares & Equities

Focus on balance sheets, sustainable dividend growth and yield. This provides consistent cash flow into the portfolio for either reinvestment opportunities or supplemental income.

Independent of whether the investment is in bonds, preferred shares or equities, we focus on businesses that have very low leverage, significant liquid assets and transparent balance sheets. We are particularly concerned with financial stocks and have limited our exposure to the sector.

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We continue to focus on sectors in the economy that are essential and scarce and can re-price their product or service in the face of a changing cost structure and volatile exchange rates in the global currency markets. This leads us to focus on businesses with lower fixed costs, high barriers of entry (preferable if business operates in an oligopolistic industry), inelastic demand such as infrastructure, consumer staples, utilities, agriculture, water and healthcare.

### 3. Precious metals – Mining Shares

Gold and silver mining businesses provide a hedge or insurance against the easy money policies of the central bankers. Over thousands of years, gold and silver have effectively operated as wonderful stores of value and protected investors at moments when government cannot be trusted. Today is such a day! The money printing, currency devaluations, trade frictions between countries and confiscatory government policies all point to the need for prudent precious metals exposure. This is also an area that is trading at very low valuations. We believe that high quality gold and silver miners offers exceptional upside potential in the face of the global debt challenges.

Armed with valuable information we must apply discipline, knowledge and understanding to the current situation. We believe that the positions we have built and the companies we are currently adding to your portfolio will be able to navigate the ex ante challenges as well as maintain and grow value for the owners of these assets. We also maintain higher than normal cash positions (deposit accounts) that provide us with the immediate liquidity to take advantage of future outsized swings in the market. We live in challenging days. This in no way deters us from the job before us.

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