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Are we there yet?

"If it costs nothing to produce, is it worth anything?" Jim Grant

Investment Update

A. Are we there yet?

As we celebrate our fifth year in business it's worthwhile to reflect on the past five years! During this period, we have consistently informed our investors about the challenges facing capital markets and have remained very conservative in our approach. For some of our clients I'm sure that our repeated warnings sound like the old proverbial "broken record player". Nevertheless, we remain cautious and have not changed our tune, given the economic fundamentals. Despite our caution we view the market opportunistically and continue to ferret out wonderful businesses trading at attractive valuations. We love it when the market does the "wild thing" especially on the downside! After all, in our business, one person's pain is another person's gain! Watching the current bloodbath in oil and gas stocks underscores this for us, as we hunt for great deals.

Despite our overall warnings and concerns, stock and bond markets throughout much of the industrial world (particularly North America) have made steady advances over the past five years. Fortunately, we have held positions in a handful of great businesses that have also advanced significantly during this period, and have provided solid gains for our clients. Regardless of market sentiment or the talking heads on CNBC & BNN, it is crucial that our market behaviour is controlled by the fundamentals of the market and the businesses we invest in. When we consider the generous market valuations and the major macroeconomic headwinds facing us we continue to be very careful. Our focus is to protect your money and take advantage of major market swings.

With all the excitement surrounding the market it is important to revisit some of the primary headwinds facing investors.

1. Debt and Derivatives

The number one challenge facing the global economy is the unprecedented levels of debt. Over the past five years the aggregate level of debt and derivatives has continued to escalate. Governments are by far the largest contributors to the growing debt. Every major government in the world continues to run fiscal deficits and add to their debt/GDP ratio. In effect, this means the debt storm that we have discussed with you, is getting worse, not better. In terms of derivatives, the global banks continue to expand the volume of derivatives. Consider two important markers: total global credit market debt is now well over USD $240 trillion, up from USD $80 trillion just 12 years ago. The value of global derivatives is approximately USD $1.0 quadrillion. Put those numbers in some perspective; global GDP is approximately USD $74 trillion. The growth in global debt and derivatives is not sustainable.

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2. Unfunded Liabilities

Over the past 4-5 decades Western Governments have made outrageous promises to their citizens. In a previous newsletter we referred to this as living in a "decadent democracy". Examples of promises and liabilities that the government has assumed on our behalf include pensions (especially public sector pensions), healthcare, social welfare and education. **These promises are massive and according to most estimates well in excess of USD $100 trillion globally with very little money set aside to pay for these promises.** Simply stated, these entitlement promises will have to be dramatically reduced.

3. Aging Demographics

The majority of the world is experiencing a dramatic aging of their populations. Lower birth rates, high levels of abortion (100,000 per year in Canada) and the undermining of the traditional family is leading to conditions that can only be described as catastrophic. **A birth rate of 1.4 children per woman (average in most developed countries) translates into the following: 100 grandparents will produce 29 great grandkids!** For indebted nations addicted to state run healthcare, early retirement, subsidized education and all sorts of other welfare schemes, this population inversion will inevitably lead to both social and economic stress. Today, Japan is leading the way, Europe is on their heels, and China is following close behind. **Expect slower economic growth.**

4. ZIRP & NIRP (Zero & Negative Interest Rate Policy)

We have written extensively on the issue of zero and even negative interest rates. This policy punishes savers, erodes long-term capital investments, supports weak or zombie companies, increases the size of the state, and makes the population more dependent on government. In addition to these problems, it leads to the overpricing of financial assets and real estate. Getting off this addiction to low interest rates will be painful. As investors, we must be careful to avoid overpriced assets and remain vigilant in the valuation of our investments. A zero interest rate policy is not sustainable nor is it healthy for the long-term prosperity of the global economy.

5. Quantitative Easing – Money Printing

Increasing the money supply, also known as money printing or quantitative easing, has taken place at an unprecedented pace over the past 5 years. With all major central banks in the world printing money, the money supply, over the past five years has increased from USD $3 trillion to over USD $14 trillion. Central bankers and economists can call this what they like, but the truth is, this expansion of the money supply, is simply the debasement of our money. Printing money to solve a debt crisis will not, and has not worked.

When we consider these challenges it causes us to be very careful. **In the end we know that the market is manic-depressive and the fundamentals of the businesses we are investing in is of paramount importance.** But as we have stated many times, we must

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incorporate into our thinking and decision making framework the artificial nature of today's markets given the steroids of zero to negative interest rates and the grotesque use of money printing and debt accumulation. There will be an end point to this monetary insanity! Are we there yet? No! But every day draws us closer to that point.

B. Central Banks Buying More than Short-term Government Bonds!

One of the most disturbing developments over the past six years is the increasing use of printed money to buy up more and more of the world's financial assets. Many of you understand that central banks as constituted today have the ability to create as much "money" as they like through mere accounting entries, at zero cost. As central banks continue to print money they must expand their holdings of financial assets. In the "old days" (prior to 2007) central banks would expand the money supply by purchasing short-term government debt. The idea or theory was that central banks only directly influence short-term interest rates, as apart of their basic monetary policy. Given the severity of the financial crisis in 2008 and beyond, central banks decided not only to directly influence short-term interest rates but also long-term interest rates by buying up long-term government bonds. In effect as central banks bid up the prices of long-term bonds, buy purchasing them, they drive down interest rates. It didn't take long for the central banks to use newly minted, zero cost money (counterfeit money!) to drive down the whole yield curve (all interest rates)! Not satisfied with that, central banks began buying up mortgage debt and other private debt in order to manipulate interest rates down for all segments of the lending public. This was particularly true for homeowners. Unfortunately, driving down the interest rates on mortgages only serves to drive up the price of real estate making it even more unaffordable for the masses and young people starting out and looking to buy into an overpriced market.

As we have discussed many times the real elephant in the room is that we have too much debt! Adding more debt just to keep the game going is not wise, especially when that debt cannot be serviced or paid back. How much more of this can we take? How much further can interest rates fall? Are we there yet? Unfortunately, this is not the end of the story!

Over the past few years, central banks have started to purchase not only long-term government and private debt they have begun buying equities. Not satisfied with record low interest rates that have already helped to prop up the value of all financial assets and real estate they have increasingly entered into the equity markets and bought stocks! The idea is that if central banks can influence global stock markets in a positive or upward manner they will create a so-called "wealth effect". What is the wealth effect? First, make stockowners wealthier by increasing stock prices. Second, encourage some of these stockowners to spend this "new wealth". Third, hope the spending trickles down to everyone else! In reality, all that has happened is that the rich have become richer and the poor poorer! The middleclass has continued to disappear under a deluge of increasing debt burdens, called mortgages, car leases and student loans!

Meanwhile central banks from China, Denmark, Japan and Switzerland are investing significant amounts of their "balance sheets" in equities. In the case of Switzerland, the SNB (Swiss National Bank) is allocating up to 15% of its balance sheet into equities. With a balance sheet of half a trillion this means they could have as much as USD $70 billion

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invested in businesses around the world. What we find astounding is that very few people seem to even care about these actions!

Stop for a moment and think about what is happening. Major central banks are printing money, out of thin air (zero cost) and then using this money not only to buy short-term government bonds, long-term government securities, mortgage securities and other private debt instruments, but now businesses in the form of equities. Does any one see anything wrong with this picture? Is this not theft? How can these policies be legal? Where does this sort of crass manipulation end? As Jim Grant so aptly stated, "If something cost nothing to produce (our money), is it worth anything?" How can that which is increasingly worthless be used to buy up permanent pieces of businesses known as stocks? How can we value securities in a market where significant purchasers of securities are using "counterfeit money" to prop up security values? How long can this house of cards continue? Are we there yet? No, but we are close!

C. Moving Forward

Given all that is currently taking place around the world 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 loss your capital! Rule number 2: go back to rule number 1. These two rules remain the focus of our investing today, especially given the artificial nature of the capital markets.

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 within the current environment.

Three years ago, in our December 2011 newsletter, we reminded our investors that there are essentially three basic elements to our portfolio creation today. We have not changed our view! They are: first, reject modern portfolio management theory; 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. This does not mean that diversification is not important, only that it must not be so expansive as to capture all the market risk.

2. Watch Your Counterparty Risk

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 tells us that governments are the highest quality counterparties. While this is true for short periods of time, it is seldom the case over longer periods of 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 given the current sovereign debt crisis is simply not true.** Government securities are in many instances the riskiest of investments. That is why we do not have any direct investments in China, Middle East, Russia and large parts of Europe. 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.

3. Make sure that 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 and risk tolerances.

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. **Cash is not trash in a declining market and can be your most valuable asset!**

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 today have durations of less than three years. We also restrict our bond purchases to entities with very strong balance sheets and quality collateral. When trouble ensues the only financial item that matters is the collateral/balance sheet of the business.

iii. Equities – the most important asset class that we invest in is equities (and to a lesser degree 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 ongoing debasement of our money! The main industries of focus remain, precious metals, through the ownership of gold and silver royalty companies, agriculture, technology, water, infrastructure, oil and gas, basic staples, healthcare and well collateralized, fee based financials.

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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 strongest businesses should continue to prove out over time.

D. Fourth Quarter & Annual Review

Overall 2014 was a strong year for North American equity markets. It was also a good year for bonds given the further drop in interest rates. We expect 2015 to be much more challenging across all asset classes and have done our best to prepare for this. We have included the quarterly and annual returns for a number of important financial barometers, for your information, in the chart below. In terms of ROCKLINC accounts, overall they advanced by 12.0% during 2014 and by 2.9% during the fourth quarter. These numbers were earned based on approximately 65% invested in equities and the remainder in cash, short-term bonds and preferred shares. These performance numbers will vary by client since all our accounts are managed separately and based on client circumstances and risk tolerances.

The two most significant moves in 2014 from a Canadian investor's perspective were the dramatic drop in our dollar compared to the USD and the plunge in oil prices. Both of these moves have continued so far in the first two weeks of 2015. For Canadian dollar accounts the drop in the Canadian dollar, given our large US exposure actually helped to increase the value of our accounts when converted back to Canadian dollars. On average, we estimate that the drop in our dollar added 3-4% points to the value of your account when converted to Canadian dollars. Although we cannot take credit for this move we are pleased to take advantage of it and will look to capitalize on the weak Canadian dollar moving forward.

The large drop in the oil price is more concerning for investors and especially for Canadians. We are watching this situation closely. Our investments in the oil sector are quite small when compared to the major North American benchmarks. Currently we have approximately 6% of our assets in oil businesses. Our oil investments are in Suncor, Exxon, BP and Canadian Natural Resources. Each of these businesses will not only survive the current weak conditions, but should emerge with better long-term opportunities, as weak players are eliminated from the competitive landscape. Despite the future opportunities we are presently cautious and have not added to our sector exposure so far. There will be a time to add, we do not believe we are there yet!

	December 31, 2014 Close	Quarterly Returns	Yearly Returns
S&P/TSX Composite Index	14,633	-2.19%	7.69%
S&P 500 (USD)	2,059	5.79%	11.81%
Dow Jones Industrial Average	17,839	6.08%	8.16%
FTSE TMX Canada Universe Bond Index	961	2.70%	8.79%
CADUSD	$0.86	-3.98%	-6.45%
Brent Crude Oil Spot	$55.27	-37.81%	-45.21%
NYMEX Gas - 12 month	$3.09	-25.02%	-26.90%
Gold (USD/Oz.)	$1206	-0.90%	0.17%
Silver Spot (USD/Oz.)	$15.97	-6.66%	-18.10%
Copper Spot (USD/lb.)	$2.84	-5.65%	-14.46%

Lastly, we have provided you with the approximate stock price changes (converted to Canadian dollars and including dividends) during 2014 for our top 12 equity positions as at December 31, 2014. These companies account for approximately 45% of our total equity weight. You can see from this list, a significant range in terms of price movements. We believe it will be tougher slugging in 2015! As you can also see from this list we maintain large positions in fee based financials and royalty businesses, infrastructure, water and industrial businesses as well as technology. The best performing sector amongst our holdings last year was the infrastructure sector with a return of over 30% and the worst performing sector was the energy sector which was flat for the year while quite negative in the fourth quarter as oil and gas prices plummeted in the back half of 2014.

Alaris Royalty	23.3%
Agrium	16.7%
Brookfield Infrastructure	21.9%
Brookfield Renewable	34.5%
Ecolab	7.8%
First Capital Realty	10.1%
Franco-Nevada	34.1%
Johnson & Johnson	23.6%
Oracle	25.2%
Suncor	1.8%
TD Bank	14.5%
TransCanada Corp.	21.5%

This section provides our clients with more information about some of their investments. Some Key Events during the Fourth Quarter of 2014: (Click on the link for news article)

Canadian Updates
ValueAct takes 5.7% stake in Agrium
Brookfield Asset Management Proposes to Acquire 30% of Brookfield Residential Properties Not Currently Owned
TD Bank Group Welcomes Bharat Masrani as New Group President and CEO
Alaris Royalty Corp. Announces a US$35 Million Contribution to a New Partner and US$26.9

Million Repurchase by Quetico
First Capital Realty names Adam Paul as new President and Chief Executive Officer
Enbridge Inc. Acquires Interest in $650 Million Value Wind Portfolio From E.ON

US News
American Water Reports Solid Third Quarter 2014 Results; Achieves Growth
Ecolab raises outlook as profit, revenue rise
Oracle rains on Salesforce and Workday in cloud computing
Google is now bigger than Mother Russia's entire market
Church & Dwight Announces Matthew T. Farrell Has Been Named Chief Operating Officer / Chief Financial Officer
New Acquisition Expands Pennsylvania American Water's Roster of Wastewater Operations

Given the challenges ahead we will remain conservatively invested in strong companies, operating in decent long-term industries and are prepared to take advantage of market swings! We have compiled a list of exceptional companies we would love to own, but only at lower prices. We are looking forward to owning some of these companies in 2015 when they reach our price targets. Are we there yet? No, but we are close! As we stated earlier in this newsletter, the best offence is a good defense, and we have some great companies to provide us cover. We also have significant cash positions that can quickly be put to work!

If you have any questions pertaining to your account please call or email for an appointment.

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