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Decadent Democracy

"Government is the great fiction, through which everybody endeavors to live at the expense of everyone else." Frederic Bastiat, French Economist (1801-1850)

"In general, the art of government consists of taking as much money as possible from one party of the citizens to give to the other." Voltaire (1764)

Investment Update

A. Decadent Democracy

During a recent commencement address at Niagara University, Pulitzer Prize winner Dr. George F. Will encouraged the 2014 graduates to stand against, what he referred to as, "decadent democracy". According to Dr. Will, decadent democracy occurs when one block of voters, uses their votes to benefit themselves at the expense of others, and in a manner that is detrimental to the long-term prosperity of the country. Dr. Will argues that the aging baby boomers are using their voting power to transfer large swaths of wealth from future generations to themselves. By demanding increasing levels of social programs, including, pension and healthcare benefits, they cannot afford, they are forcing governments to go deeper and deeper into debt and thus indebting the next generation.

While I listened to George Will, I immediately thought about our recent election in Ontario. On June 12th Ontario voters rewarded Kathleen Wynne with a majority government. But how could Ontario voters re-elect a government that has been involved in as many serious and costly scandals as this government? How could the Ontario citizenry re-elect a government that has over the past 10 years run up the provincial debt to unsustainable, unconscionable and immoral levels? Political pundits have offered their analysis of the election but if we bottom line it, there are really only two answers one can offer; either Ontario voters do not have a clue what is happening in Queen's Park or they do not care.

Ontario voters, by re-electing the Liberal party, overwhelmingly supported "big government". They did this despite the ongoing damage and costs this government has inflicted on Ontario. Within 12 hours of the election result, the bond markets and international credit rating agencies sent powerful messages to the Ontario government and its citizens. Straighten out your financial mess or your borrowing costs will sky rocket and your access to the credit markets will be more difficult! As we discussed in previous newsletters, Ontario's credit rating should have been cut several years ago, given the massive build up of debt and irresponsible financial policies of the Liberal government. (This is the reason we have minimal exposure to Ontario bonds in client portfolios.)

Consider the following: *"Seven consecutive years of deficit spending has fuelled growing government debt. Ontario's debt will hit $289.3 billion this year and is projected to reach $324.5 billion (almost 40% of the Ontario economy) by 2017/18, more than double the $138.8 billion debt (or 27.5% of the economy) in 2003/04 when the Liberals came to power."*[i] Ontario's finances under the liberal government have become a train wreck.

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Once wealthy and prosperous Ontario has become a "have-not" province relying on transfer payments from other Canadian provinces to subsidize it's spending.

Voting based on what you can extract today and kicking the bill into the future is the world we operate in. Although Dr. Will's warning and admonition to the graduating class of 2014 was spoken in the context of the United States we see the same problems in Ontario and his comments are also apropos to Europe and Japan. Easy credit and easy access to debt has simply exacerbated the global desire to spend the future today.

Citizens throughout much of the world seem oblivious to the words of Friedrich Hayek, "the more the state plans the more difficult planning becomes for the individual." They are also unaware, or do not believe in the "Rahn Curve" that highlights the economic fact that as the size of government expands the rate of economic growth slows. This should be intuitively obvious! If government is the most unproductive and wasteful part of the economy, then growing the size of government has to be the worst financial decision a society can make. History has repeatedly shown that when government is allowed to exceed 20% of GDP it becomes increasing difficult to slow the growth of government. (Note that today governments consume up to 50% of the GDP in most of the developed countries). Citizens become dependent on the government and it's spending! The spigot is seldom shut off until the whole economy is driven into a financial crisis. Decadent democracy, will actually reward incompetence and keep in place corrupt governments despite their obvious shortcomings. This is the situation we face in Ontario in 2014! We reward corrupt and incompetent governments! This is the situation in most countries around the world.

Ronald Reagan stated many times, *"Government is not a solution to our problem, government, is the problem."* And as Barry Goldwater pointed out many years ago, *"the government that is big enough to give you all you want is big enough to take it all away."* Governments around the world have become too large. Their size is hurting economic growth, indebting future generations and facilitating the abuse of power on behalf of the central banks. Governments use their central banks as "piggy banks" to monetize their debts by printing money and manipulating interest rates to dangerously low levels. While savers are emasculated by low rates, debtors are rewarded. This is the worst trade-off an economy can make over the long-term! We are all going to pay for this gross economic incompetence. As investors all we can attempt, is to invest around this folly.

B. NIRP Has Arrived & The Devastating Impact of Zero Interest Rates

Goodbye ZIRP (zero interest rate policy), hello NIRP (negative interest rate policy)! On June 5th the European Central Bank (ECB) officially lowered the deposit rate for banks to **negative** 0.15%. In other words, banks holding any deposits at the ECB will have to pay them for the privilege of holding their money. As some have referred to it, we have entered the "monetary twilight zone"! Others have simply stated the obvious; it's a mad, mad world and getting madder! To think that economies are actually improving at the same time that interest rates are zero and even negative, and overall debt grows at a faster rate than the overall economy is sheer economic madness.

The consequences of pursuing zero interest rate policies across the globe are devastating for the long-term health of the global economy. The only way to ensure that booms and

busts are kept to a minimum, and capital is channeled or allocated to the right people and businesses in the economy, is to let interest rates reflect true market conditions! When credit is "free" and not priced properly by the capital markets, governments, businesses and individuals will all shorten their time horizons and be encouraged to spend the future today.

But what's wrong with all that free money? Don't we need everyone to go out and spend as much as they can? Aren't we told how bad and evil austerity is for our economy? What we should be concerned about is the devastating impact of zero to negative interest rates on our economy and its long-term growth prospects. The low or zero interest rate policies of our global central banks are leading to the following long-term problems:[ii]

1. Structurally low interest rates encourage "a culture of instant gratification." This is particularly true within the confines of a decadent and faithless culture. Too much of our consumption is not financed with savings, but by assuming larger and larger quantities of debt. A debt-based society is seldom interested in long-term economic activities but in present consumption. Worse, declining interest rates make it easier and easier for governments to promise more and more while the interest burden or expense of their spending and increasing indebtedness is not felt until it is too late.

2. The low interest rate environment today punishes savers and rewards debtors. The longer the interest rates remain below market rates the greater is the pressure to misallocate capital. This can lead to harmful bubbles and suboptimal investing which negatively impacts everyone long-term. In the case of corporations, the low interest rate environment has wrongly incentivized companies to invest less in the future, and more in buying back their own stock, regardless of the overvaluation of their own shares! Share repurchases have grown substantially and in the US alone, are running at an annualized rate of approximately $600 billion. In many cases, share repurchases are funded by increased borrowings, justified by record low interest rates. This is one reason for the low level of capital spending on the part of corporations.

3. The combination of low interest rates and printed money leads to massive asset price inflation, such as stocks, real estate and art. Young people are increasingly priced out of the market since incomes cannot keep pace with asset price inflation.

4. Financial markets are structurally weakened by the reckless behaviour of market participants who use low cost funds to make investments more risky using excessive leverage. This can also be seen in emerging markets through what investors call "carry trades."

5. Human behaviour is shaped in a negative manner with low interest rates and easy money policies. Any society that watches its purchasing power being continually eroded cares less about frugality and thrift and becomes increasingly comfortable with debt as a rational choice.

6. Within a low interest rate environment the acquisition of personal wealth and capital becomes increasingly difficult. Money is no longer a store of value and

those who do not own the scarce and productive capital assets watch whatever wealth they had dwindle away by inflation. Only the owners of the productive assets can stay ahead of the game. Wealth disparities are exacerbated.

7. Incentives for fiscal discipline on the part of government decrease dramatically. Central banks buy time for governments. Large deficits don't seem so ominous, there is little incentive to implement reform or run the affairs of the State in a prudent manner.

8. You encourage the emergence of "zombie-banks and zombie-companies". Very low interest rates prevent the healthy process of creative destruction. Zero interest rates make it possible for companies with low profitability to survive. Banks and life insurance companies in particular can carry large amounts of loans and bonds that are overvalued and would be worth much less, if anything in some circumstances, in an environment of higher interest rates. This will become obvious when rates do rise and loans become non-performing!

9. Unjust redistribution of wealth takes place in an environment of zero rates and fresh money printing. The problem is that newly minted money is neither uniformly nor simultaneously distributed to the overall population. As a result, monetary expansion is never neutral! There is a permanent transfer of wealth from those who get access to the money last to those who receive it first!

As we have repeatedly emphasized to our investors, the current monetary conditions are unsustainable and harmful to the long-term prosperity of our economy. In the midst of this madness we must invest in a manner that will protect our wealth, grow our purchasing power and keep us from being pulled into another central bank induced financial bubble. Zero or negative interest rates are immoral, dangerous and unsustainable we must be prepared for the day in which this "hall of mirrors" is shattered and reality sets in.

Jim Grant observes, *"My fear is that because interest rates are suppressed, therefore earnings are inflated. So when rates go up…the hall of mirrors is shattered and we look at each other and see what actually is real rather than what the Fed wants us to believe."*

C. First Half Review

Despite the challenging environment, stock markets continued to push higher during the first six months of 2014. We have prepared a chart that lays out the six-month returns on a number of important stock and bond indexes as well as a number of critical commodities. Consistent with the first quarter the Canadian Stock market continued to outpace US stock markets after several years of underperformance. One of the largest moves in the quarter was the resurgence of the Canadian dollar, which gained back almost all of its first quarter losses against the US dollar. Since we hold substantial US investments this was a slight head wind in the second quarter but of little consequence during the first six months of the year.

Across our book of business at ROCKLINC, which varies substantially by client, we advanced by approximately 10% during the first half of the year, which compares well with indexes, and the fact we are approximately 65% invested in equities, with the remainder in preferred shares, bonds and deposit accounts. Some of the best performing securities

during the first six months included many of the securities that were beaten down last year, especially securities related to the precious metals sector. For example, Sandstorm Gold Ltd., Silver Wheaton Corp., New Gold Inc. and Franco-Nevada Corporation advanced by 61.4%, 31%, 22%, and 42% respectively. We remain committed to investing in this important sector given the massive indebtedness of the global economy, and the easy money conditions we have just highlighted for you in this newsletter. We believe that our holdings in this space, despite significant moves so far this year are still undervalued and provide substantial upside. Another important sector that performed admirably during the first half was the oil and gas sector. Our largest holding in this sector, Suncor Energy Inc., advanced by over 23%.

	June 30, 2014 Close	6 months
S&P/TSX Composite Index	15,146	11.19%
S&P 500 (USD)	1,960	6.05%
Dow Jones Industrial Average	16,810	1.51%
FTSE TMX Canada Universe Bond Index		4.82%
CADUSD	$0.9376	-0.45%
Brent Crude Oil Spot	$111.03	4.05%
NYMEX Gas - 12month	$4.32	3.32%
Gold Spot (USD/Oz)	$1315	9.2%
Silver Spot (USD/Oz)	$20.87	7.03%
Copper Spot (USD/lb)	$3.16	-6.51%

Another new addition to this newsletter is the next section, which provides you with a number of important links to some of the main news stories concerning some of our investments during the second quarter. This section provides our clients with more information about their investments.

Some Key Events during the Second Quarter: (Click on the link for news article)

Canadian Holdings

AGU: Agrium enters agreement to sell Turf and Ornamental business to Koch Agronomic Services for approximately $85 million.
BEP: Brookfield Renewable acquires remaining interest in 417 MW Safe Harbor hydroelectric facility for $613 million.
TRP: TransCanada to Proceed With $1.9 Billion Merrick Mainline Pipeline Project. The proposed project will be an extension from the existing Groundbirch Mainline section of the NGTL System beginning near Dawson Creek, B.C. to its end point near the community

of Summit Lake, B.C. The $1.9 billion project will consist of approximately 260 kilometres (161 miles) of 48-inch diameter pipe.
TRP: TransCanada Disappointed and Frustrated with Keystone Delay - Another delay is inexplicable. The first leg of our Keystone pipeline began shipping oil to refineries outside of St. Louis in 2010. It is about the same length of pipe as Keystone XL, carries the same oil and also crosses the 49th parallel. It took just 21 months to study and approve. After more than 2,000 days, five exhaustive environmental reviews and over 17,000 pages of scientific data Keystone XL continues to languish. Our Keystone pipeline has safely delivered more than 600 million barrels of crude oil to U.S. refineries, replacing foreign off-shore oil.
ENB: Northern Gateway Receives Approval from Government of Canada.

International Holdings

ORCL: Oracle has agreed to buy Micros Systems for $5.3 billion, as Oracle looks to become the #1 Software as a Service(SaaS) provider in the world.
GOOGL: Google acquired 13 companies in the second quarter alone, with two notable acquisition being DropCam for $555 million and SkyBox Imaging for $500 million.
KO: Coca-Cola has raised its stake in Keurig Green Mountain to 16 percent from 10 percent, making it the largest shareholder of the maker of the popular Keurig one-cup coffee brewer.
NSRGY: Nestlé SA is paying $1.4 billion for the rights to a handful of skin care products from Valeant Pharmaceuticals Inc. in a move that will bolster the Swiss food giant's newly established dermatology unit.

D. Looking Ahead

We believe that many of our best opportunities lie ahead because we are focused on the playing field, and what is actually happening, and not on the illusion that our governments and central banks have created for investors. As value investment guru Ben Graham clearly stated; ***"Have the courage of your knowledge and experience. If you have formed a conclusion from the facts and if you know your judgment is sound, act on it - even though others may hesitate or differ. You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."*** We are positioned for what we believe are the long-term facts and are not dissuaded by the cacophony of voices all around us.

As we have stated in previous newsletters, at some point, debt will matter, it always does! At some point, an unsustainable social welfare system will have to be restructured and the decadent voters will no longer have their way. What is not sustainable will not be sustained! At some point, interest rates will have to reflect true market risk! At some point, the market will realize that a tiny handful of unelected central bankers really don't know what they are doing and are not the magicians some have made them out to be. On that day, the revelry will end and the hangover will begin. Those who have remained sober, vigilant and well prepared will enjoy the brightness of the new day and their discipline will be rewarded.

In the mean time, we remain focused on buying great businesses, at attractive prices operating in vital industries. The most important characteristics of the businesses we are investing in continue to be: 1) firms that are well-financed (strong balance sheet), 2)

prudent capital allocators, with rational dividend policies and share repurchase plans, 3) sell essential products or services, and 4) control and own scarce assets in safe countries that should be least impacted by our current easy monetary policies and ongoing currency debasement. Our largest sector exposures (alphabetically) continue to be agriculture, consumer staples, energy, financial services, infrastructure, real estate, precious metals, technology and water. We also maintain a portion of every client's portfolio in money market securities. We want to ensure that we have the firepower to take full advantage of any major pull back in global markets. Owning great assets at attractive prices in essential sectors, positions us for the inevitable ups and downs of the market.

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[i] Huff Post Politics, "Wynne, Stop Ontario's Credit Rating From Plummeting Further", June 26, 2014.
[ii] Incrementum (Liechtenstein), "In Gold we Trust 2014 – Extended Version", June 24, 2014, pages 32-34.