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The Tale of Two Markets

Investment Update

A. The Year that was 2013

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way. . . ."

These famous lines are used by Charles Dickens to begin his book **A Tale of Two Cities**. This passage makes use of what is called anaphora, the repetition of a phrase at the beginning of consecutive clauses. Dickens uses opposing pairs, in this opening passage, to initiate one of the novel's most prominent motifs and structural figures—that of doubles. The use of doubles includes a number of comparisons including the comparison of two cities, London and Paris. Using this motif and applying it to the global stock markets in 2013 we had "A Tale of Two Markets".

Although Canadian share prices are up this year, the gains pale in comparison to those in the U.S. At the time of writing this report, our benchmark S&P/TSX Composite is showing a year-to-date increase of approximately 5%. When you compare that to the S&P 500, a broad measure of U.S. stocks, which is now up approximately 22%, you can see the wide divergence.

What are the key factors that have created this large disparity in 2013? There are at least four primary reasons. First, the Canadian mining sector as a whole has been eviscerated. It has been a classic "annus horribilus" for Canadian miners, and in particular, mining firms in the gold and silver sectors. The S&P/TSX Global Gold Index, which is largely composed of Canadian companies, is down almost 50 per cent this year, making it the worst performing sector by a large margin on the TSX. Part of the reason for this drop is the almost 25% drop in the price of gold bullion. The other part of the reason for the drop is due to poor management. In the "good years" many of the firms made overpriced acquisitions. Today, they are writing down the value of these acquisitions. In other cases, companies operating in high-risk political jurisdictions have been faced with significant interference by cash strapped governments. In yet other cases, environmental concerns and massive cost overruns are hampering the value of the companies stock. Regardless of the reasons, it has been a brutal year for the miners.

The second reason for the large divergence between the U.S. and Canadian stock exchanges is the large increase in U.S. information technology stocks, including the social media stocks. The large gain in the NASDAQ Composite underscores this for us. We have not seen this level of excitement in the technology world since the big bubble in 1999 and 2000. Companies like Google, Microsoft, Netflix and Facebook among many others have soared in value. Although we in Canada have had some smaller success stories in this space, all of us are aware of the Canadian "former heavy weight" Blackberry, which has in dramatic fashion moved the opposite way, and is down approximately 50% this year.

The third reason is the rebound in the U.S. banking sector. While the Canadian financial sector has advanced and turned in a good year, mainly due to a renewed interest and strength in the

insurance sector, the S&P Financials Index in the U.S. is up approximately 25% or twice the Canadian financial sector return. Lastly, the U.S. market, for many global investors, represents the world's most liquid market. Given the challenges around the world, investing in U.S. based businesses, many of them global leaders, with strong balance sheets and powerful business franchises, has been the safest bet this year.

What about the year ahead? It's hard to conceive of the Canadian market underperforming the U.S. market in 2014. Given the significant run up in stock prices in the U.S. and the gross underperformance of the Canadian mining sector in 2013, history and economic fundamentals are on the side of the undervalued sectors rebounding, and often in significant amounts. Convergence in stock prices and returns is as fundamental as gravity, and whether we experience this in 2014 or 2015, we will experience it. Regardless, our focus remains on investing in great individual businesses, operating in long-term growth sectors (including a couple of very profitable and cheap miners!) and this has not, and will not change, as we look forward to 2014.

B. Investing in the Agriculture Industry

One of the industries we continued to allocate capital to throughout 2013 was the agricultural industry. There are numerous reasons why we are interested in this important sector. Here are some of the most important ones.

1. The world's population is now in excess of 7 billion and is expected to reach 9 billion by 2050. This means the demand for greater agricultural production will continue for a long time.

2. Changing diet, increased calories and consumption of protein. Consider the following: It takes 1,000 tons of water to make 1 ton of grain and 7 tons of grain to produce 1 ton of beef.

3. Arable land is disappearing at a rapid pace. In 1960 the world had 2.8 acres/person of arable land. Currently the ratio has dropped to 1.2 acres/person and this is expected to drop further to less than one arable acre/person in 2030.

4. Over the past decade there has been a large increase in the use of agricultural commodities for other than food use. For example up to 30% of corn grown in the US is used for ethanol.

5. Over the past two decades the inventory levels of many agricultural commodities have continued to edge lower. One research report suggests that we must produce as much food in the next 40 years as we have produced in all of history.[1]

6. Currently 1.4 billion people live in regions where there is not enough water to provide for the agricultural industry in those areas. We discussed this issue in our June 2013 Newsletter as a reason for making investments in the water industry. Throughout many populous areas in the world there is an emerging water shortage. This puts more pressure on the production of food in areas with adequate water reserves.

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[1] GlobalFundExchange.com

7. Food security is power and this fact is becoming increasingly important in our world today, as in the past. Outsourcing food production to hostile countries is very risky. There is increased pressure to grow more and more of your own domestic consumption.

8. Wherever there is a “crisis” or “scarcity” of an essential product there is an opportunity for investors!

At this point we have divided our agricultural investments into three key areas: equipment, finance and supplies. Given the increasing growth and demand for food, there will be a commensurate increased in the demand for high quality farm implements and equipment. Currently many of our clients have a position in Deere & Company. Anyone who has a John Deere product appreciates the advertising tag line, “Nothing runs like a Deere”.

There is also a massive demand for financial capital, to both help farmers increase their productivity (buy equipment and invest back in their farms), and in other cases, to assist them in consolidating a very fragmented industry. Owners of farms today, on average, have never been older and with fewer children entering the business, many are looking to sell their farms. This is wonderful opportunity for financial businesses that understand the agricultural business and are interested in partnering with farmers. In this segment, a number of our clients own a small position in a creative finance company called Input Capital.

Lastly, we have a substantial position in Agrium. Agrium is a major retail supplier of agricultural products and services in North and South America and a leading global producer and marketer of agricultural nutrients and industrial products. They produce and market three primary groups of nutrients: nitrogen, phosphate and potash as well as controlled-release fertilizers and micronutrients. A key differentiator of Agrium is that they are the only publicly traded company that crosses the entire agricultural value-chain.

There are significant long-term trends that will drive global agricultural innovation and opportunity. We view this industry as one of best places to buy great businesses, and will continue to add to our positions in this sector, as valuations permit throughout 2014.

C. Looking Ahead – The Federal Reserve’s 100th Birthday & Precious Metals!

The **Federal Reserve System** (also known as the **Federal Reserve**, and informally as the **Fed**) is the central banking system of the United States. It was created 100 years ago this month, on December 23, 1913, with the enactment of the Federal Reserve Act. We are told that the U.S. Congress established two primary objectives for monetary policy in the Federal Reserve Act. First, maximum employment and second, stable prices. These two objectives are often referred to as the Federal Reserve's dual mandate.

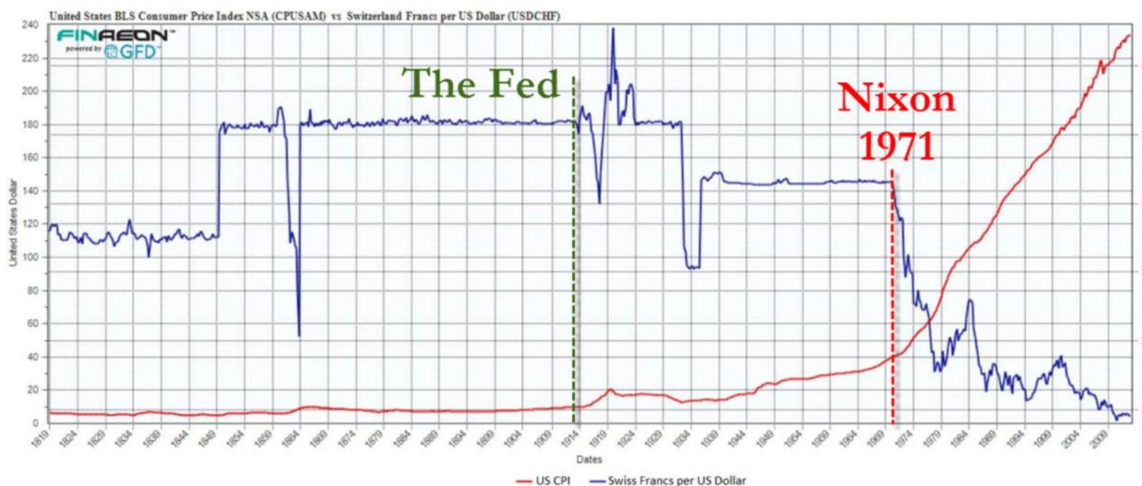
What we are not told is that the basic plan for the Federal Reserve System was actually drafted at a secret meeting held in November of 1910, at the private resort of J.P. Morgan, on Jekyll

Island off the coast of Georgia.[2] Those who attended represented the great financial institutions of Wall Street and Europe. Their stated objectives seldom discussed, nor widely understood can be reduced to five primary objectives as Edward Griffin lays out so well in his book entitled, The Creature from Jekyll Island.

1. Stop the growing competition from the nation's newer banks. (Shrink the number of banks and lending institutions.)
2. Obtain a franchise to create money out of nothing for the purpose of lending. (Today we call this quantitative easing.)
3. Control the reserves of all banks so that the more reckless ones would not be exposed to currency drains and bank runs.
4. In case of a financial emergency have the taxpayer to pick up the inevitable losses.
5. Convince the Congress that the purpose was to protect the public.

For the purposes of this write-up let me underscore the following point. In terms of their two stated goals, price stability and full employment the Federal Reserve System has been an unmitigated disaster. When it comes to the banker's five objectives, less competition, more control over the banking system, taxpayer bailouts and a huge wealth transfer from the real economy to the financial economy, the system has been a complete success!

Note the chart below, which spans the last 200 years. During this period you can see the obvious difference between the 100 years without the Federal Reserve (the first 100 years) and 100 years with the Federal Reserve. Note that during the last 40 years we have been operating without the discipline of a gold standard.



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[2] G. Edward Griffin, The Creature from Jekyll Island, A Second Look at the Federal Reserve, 5th Edition. This is the definite work on the formation and objectives of the Federal Reserve System.

What do you observe? Note the red line represents the Consumer Price Index, or the level of prices. Until the time of the Fed there was very little movement in prices. Once the Fed was created, in 1913, you can observe the immediate increase in prices. After, the US dollar was removed from the gold standard by Nixon the pace of price increases goes parabolic. The blue line compares the US dollar to the Swiss currency, which until recent days would parallel the value of gold. Other than for a brief period of time during the civil war in the 1860s the dollar held and increased in value. Post the inception of the Fed in 1913 the astounding drop in the value of the dollar is clear.

Our basic point is simple, do not trust the Federal Reserve, they are in the business of facilitating debt creation and undermining the purchasing value of currencies. This is why we own productive long-term assets including a portfolio weighting in precious metals. These types of assets hold their purchasing power overtime, whereas all fiat currencies in history have gone to zero!

Another way of understanding this phenomenon is to consider Philipp Bagus recent article published on December 13, 2013 in the Mises Daily. Bagus does a wonderful job summarizing our thinking when it comes to paper currency and the current challenges facing our global financial system.[3] I have summarized his article for you but still encourage you to read the original article.

A paper or fiat currency system with no collateral backing other than a government promise contains the seeds of its own destruction. The temptation for the government to increase the money supply over time is irresistible. In such a system as the money supply increases the economy is faced with increasing prices or inflation. In this situation, it does not make much sense to save in cash in order to purchase assets later. A better strategy is to use debt today to purchase assets today and then pay back the debts later with devalued currency. A paper money system **will always** lead to the excessive use of debt.

This is especially true of entities that expect to be bailed out, when they get into trouble. We witnessed this first hand in in 2008 and 2009 when the profligate banks and governments were bailed out by taxpayers. In fact this bailout continues today, with the manipulation of interest rates to levels that are far below free market rates, rewarding debtors at the expense of savers.

History also tells us that there is always an end point to money printing and excessive levels of debt. It looks like we are very close to that end point now. Interest rates have been cut to as close to zero as possible and there is very little economic growth in sight. Raising interest rates to more realistic levels will be very difficult without an adverse impact on the economy and a large reduction in government spending and deficits does not seem very likely either.

So will there simply be evermore money printing and close to zero interest rates, until people lose their confidence in the paper currencies? Can the paper money system be maintained or will we necessarily get a hyperinflation sooner or later? Will the Fed taper and start to reduce the money printing? What will be the result?

Philipp Bagus provides seven possibilities in how governments and central banks will try to extricate us from this difficult position.

1. ***Inflate***. *Governments and central banks can simply proceed on the path of inflation and*

[3] Philipp Bagus, How the Paper Money Experiment will End, Mises Daily, December 13, 2013.

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print all the money necessary to bail out the banking system, governments, and other over-indebted agents. This will further increase moral hazard. This option ultimately leads into hyperinflation, thereby eradicating debts. Debtors profit, savers lose. The paper wealth that people have saved over their lifetime will lose substantial value.

*2. **Default on Entitlements**. Governments can improve their financial positions by simply not fulfilling their promises. Governments may, for instance, drastically cut public pensions, social security and unemployment benefits to eliminate deficits and pay down accumulated debts. Many entitlements, which people have planned upon, will prove to be worthless.*

*3. **Repudiate Debts**. Governments can also default outright on their debts. This leads to losses for banks and insurance companies that have invested the savings of their clients in government bonds. The people see the value of their mutual funds, investment funds, and insurance plummet thereby revealing the already-occurred losses. The default of the government could lead to the collapse of the banking system.*

*4. **Financial Repression**. Another way to get out of the debt trap is financial repression. Financial repression is a way of channeling more funds to the government thereby facilitating public debt liquidation. Financial repression may consist of legislation making investment alternatives less attractive or more directly in regulation inducing investors to buy government bonds. Together with real growth and spending cuts, financial repression may work to actually reduce government debt loads.*

*5. **Pay Off Debt**. The problem of over indebtedness can also be solved through fiscal measures. The idea is to eliminate debts of governments and recapitalize banks through taxation. By reducing over indebtedness, the need for the central bank to keep interest low and to continue printing money is alleviated. The currency could be put on a sounder base again. To achieve this purpose, the government expropriates wealth on a massive scale to pay back government debts. The government simply increases existing tax rates or may employ one-time confiscatory expropriations of wealth. It uses these receipts to pay down its debts and recapitalize banks.*

*6. **Currency Reform**. There is the option of a full-fledged currency reform including a (partial) default on government debt. This option is also very attractive if one wants to eliminate over indebtedness without engaging in strong price inflation. It is like pressing the reset button and continuing with a paper money regime. Such a reform worked in Germany after the WWII (after the last war financial repression was not an option) when the old paper money, the Reichsmark, was substituted by a new paper money, the Deutsche Mark. In this case, savers who hold large amounts of the old currency are heavily expropriated, but debt loads for many people will decline.*

*7. **Bail-in**. There could be a bail-in amounting to a halfway currency reform. In a bail-in, such as occurred in Cyprus, bank creditors (savers) are converted into bank shareholders. Bank debts decrease and equity increases. The money supply is reduced. A bail-in recapitalizes the banking system, and eliminates bad debts at the same time. Equity may increase so much, that a partial default on government bonds would not threaten the stability of the banking system. Savers will suffer losses. For instance, people that invested in life insurances that in turn bought bank liabilities or government bonds will assume losses. As a result the over indebtedness of banks and governments is reduced.*

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> *Any of the seven options, or combinations of two or more options, may lie ahead. Basically, taxpayers, savers, or currency users are exploited to reduce debts and put the currency on a more stable basis. A one-time wealth tax, a currency reform or a bail-in are not very popular policy options as they make losses brutally apparent at once. The first option of inflation is much more popular with governments as it hides the costs of the bail out of over indebted agents. However, there is the danger that the inflation at some point gets out of control, and governments could increasingly ponder the other options, as these alternatives could enable a reset of the system.*

We are doing our best to both prepare for these challenges, and invest through them. Esteemed investor Howard Marks says, "*Move forward, but with Caution*." We are positioned to take advantage of these swings and look forward to 2014.

Our focus continues to be on essential industries, and within those industries, exceptional businesses, we can purchase at attractive prices, based on economic fundamentals. We continued to broaden our portfolios in the second half of the year. This not only dampens portfolio volatility, it provides our clients with a broader range of growth opportunities. Industries in which we are consciously broadening our exposure include, water (discussed in this year's second quarter newsletter), agriculture (see foregoing discussion), technology, industrial, consumer staples and select financial companies.

The area of greatest interest to us, and our investors, continues to be the precious metals sector. The price swings beginning in April of this year have been unbelievable. We have added to some positions where appropriate but are in most cases we are holding our allocations firm.

All of the fundamentals we have discussed in this newsletter, especially the declining value of paper currencies, support higher long-term precious metals prices. Stated another way, we believe that central banks will continue to debase our paper money through money printing and more debt creation. Why? The answer is quite simple; this is all they know!

The handful of businesses we own in this sector are elite companies with fortress like balance sheets. In fact, our greatest exposure is in the worlds leading royalty or streaming companies. These include, Franco-Nevada, Silver Wheaton, Royal Gold and Sandstorm Gold. Each of these companies have bullet proof balance sheets to take advantage of the brutal financing conditions facing the miners. What a great environment for these businesses to invest into some of the very best precious metals reserves in the world. With few other sources of capital for the miners, these firms can truly engage in what we call "legalized loan sharking". It's hard to believe, but this is actually one of the best environments for companies that have capital to invest to take advantage of these historically low valuations. The old sports expression, "No Pain, No Gain" is an apt one for the royalty and streaming firms we own. The pain has been felt, and the gain is on the way!

The upside potential on these companies is enormous. Time and patience is on the side of owning these great businesses. We suspect that 2014 will bring some pleasant surprises to investors in this sector.

We want to wish all our clients a Merry Christmas and Joy filled New Year!

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