ROCKLINC

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Today is Already Tomorrow

"The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups." Henry Hazlitt

Investment Update

A. First Quarter Review

The first three months of 2014 have been quite eventful for capital markets. As we suggested in our year-end review, "The Tail of Two Markets" investments that trailed the market last year will probably do much better this year. So far we have been correct. Mean reversion is alive and well in the capital markets. After a blistering year of performance last year, the major US indexes ended the first quarter of 2014, either flat or slightly positive for the year. For example, the S&P 500 and the Dow Jones Industrial Average closed up approximately 1.8% and 1% respectively. The TSX (Toronto Stock Exchange), which trailed it's US counterparts last year, managed to increase by approximately 6% during the first quarter, making it one of the best performing stock markets in the developed world this year. Since many of our holdings, are Canadian based, and trade on the TSX, performance across our holdings reflected this more bullish sentiment in Canada and most of our companies performed very well.

There were several other important moves during the first quarter that impacted your investment portfolios. First, our Canadian dollar gave up more than 4% in value when compared to the US dollar. In terms of our equity holdings, a drop in the Canadian dollar helps boost the value of most of our Canadian companies. There are two primary reasons for this. First, most of our Canadian companies have substantial operations in the US. When our dollar drops their US operations are automatically worth more when converted back to Canadian dollars. Second, a number of our Canadian businesses are commodity businesses. As you are aware, commodities are priced in US dollars. As a result, oil and gas companies or precious metals companies that are domiciled in Canada sell their commodity in US dollars. As the Canadian dollar drops in value their revenue stream, which is denominated in US dollars goes up, when converted back to depreciated Canadian dollars. In other words, we have a built in hedge to Canadian dollar weakness. While this is good news in the short run, over time it will be neutral, because our currency will move in both directions. It is much more important to invest in the right businesses and buy great long-term assets at attractive prices.

Second, after a brutal year for precious metals in 2013, gold was one of the best performing assets during the first quarter, increasing by more than 6% in USD terms while silver was up approximately 1%. When measured in Canadian dollars, both metals were up significantly (10% and 5% respectively), which helped boost the values of our precious metals positions substantially! We believe there will be much greater gains in this sector during the remainder of the year, given the reckless monetary policies of our leading central banks. Lastly, interest rates, which increased substantially during the second half of 2013, were relatively flat and dipped marginally, during the first quarter of 2014. Since we keep our fixed income "duration exposure" quite short, that is, we only invest in high quality short-term bonds there was very little volatility in the value of our holdings during the quarter. If rates do increase, as the market is pricing in, we are well positioned to take full advantage of these increases by allocating more money into the fixed income area, and

rolling over maturing bonds into longer-term positions. But, we will only do this, if we are adequately rewarded for the risk! Overall, we were well positioned for the events of the first quarter and our portfolios performed well when compared to the major indexes and given the conservative nature of our positioning. We should also point out that we do not position our portfolios based on geopolitical events. Everyone knows these types of events are highly unpredictable as to timing. The good news is that given the high quality nature of our holdings, coupled with our position in precious metals, we are typically not disadvantaged by political sabre rattling!

B. Investing in Global Infrastructure

Our single largest industry exposure is global infrastructure. We continue to research and look for great businesses operating in this diverse industry. Since, infrastructure firms provide many essential services to the communities in which they operate they are very important businesses. In order to better understand the sector, we have divided the area into four main categories. These categories are transportation, energy, communications and water. We have varying degrees of exposure to each area, through the companies we have invested in, on your behalf. Let's take a moment to look at each category.

1. Transportation

The transportation subsector includes airports, bridges, toll roads, tunnels, seaports, and railroads. Transportation assets are generally owned freehold, that is, perpetually or they can be privatized via concession agreements, typically granted by a government body. Details as to how the asset is to be managed are laid out in the concession agreements. The best example of a transportation infrastructure asset, for Greater Toronto Area residents, is the 407 Highway.

2. Energy

The energy subsector encompasses electricity transmission and distribution networks, oil and gas pipelines and storage, and electricity generation. Energy infrastructure companies generally own their assets in perpetuity providing the businesses with long-term cash flow streams.

3. Communications

The communications subsector includes broadcast satellites and wireless communication towers, that are well established across developed nations and are growing rapidly in most developing areas in the world. The technology risk is quite low, since it is the tenant leasing the space that bears most of the technology risk. Communications infrastructure assets benefit from high barriers to entry, and in many cases, operate "little jurisdictional monopolies" that provide the companies with strong pricing power.

4. Water

Water companies own and operate water treatment facilities, pipelines, and wastewater treatment facilities. The most important infrastructure assets are those related to the water industry. Without access to safe, clean and abundant water supplies, you cannot support even the smallest of communities, let alone a flourishing economy. As we have discussed in previous updates, one of the most important challenges for the global economy, is ensuring adequate access to clean water for the world's businesses and citizens.

C. Long-term Features of Infrastructure Assets

Investor interest in this sector has increased significantly in recent years. This interest has been driven by several factors including, growing demand spurred on by an increasing global population, increased global competitiveness, and a lack of spending on infrastructure by cash strapped governments. Over the past thirty years, developed countries have underspend on many of their infrastructure assets and the much needed catch-up is providing many private businesses in this area, with wonderful long-term investment opportunities. One of the key success factors is the firm's access to low cost capital, given the capital-intensive nature of these businesses. This is why the companies we have invested in maintain strong balance sheets and have favourable access to the debt and equity markets, in both good and bad markets!

As we have discussed in previous newsletters, infrastructure assets can be compelling long-term investments because they should provide stable, inflation-linked income along with significant capital growth potential, when managed effectively.

Given the extraordinary amount of debt that exists throughout the global economy, investors are well advised to own scarce, strategic and tangible assets, all attributes of leading infrastructure businesses. This strategy is one of the best ways to protect investor's from losing their long-term purchasing power, in a world of debasing currencies.

We have listed eight important attributes of infrastructure assets that help make them exceptional long-term investments. These attributes are why this sector is of such interest to us, within our investment portfolios at this time.

1. Essential services

Many infrastructure businesses are the sole providers of an essential product or service (for example water/sanitation, power or transportation services) to a particular segment of the population and usually for an extended period.

2. Strong strategic position

Many infrastructure assets are monopolistic or close to monopolistic with high barriers of entry, therefore providing a strategic and competitive advantage. When you own the only toll road in town or the major bridge into and out of town, there are few alternatives and even less competitors!

3. Relatively inelastic demand

Due to the essential nature of the services offered by infrastructure companies, demand for their products and services is very stable and much less sensitive to changes in price when compared to many other types of products and services. In the world of economics this is referred to as inelastic demand. This affords many infrastructure businesses with tremendous pricing power and the ability to earn high returns on invested capital.

4. Fixed and/or regulated cash flows

Given the essential nature of the products and services, along with substantial pricing power, infrastructure businesses are favoured with very predictable cash flows either as a result of regulation or long-term contracts or both!

5. **Inflation linkage**

In many cases the underlying revenue of infrastructure assets is linked to inflation, sometimes directly through a regulatory framework or through concession agreements linking price growth to inflation. In an environment where investors are concerned with the purchasing power of their money this increases the attractiveness of infrastructure assets.

6. **Fixed cost base**

Once an infrastructure asset is developed, ongoing operational maintenance expenditures may be relatively low and stable. As a result, increases in revenue may not result in proportionate increases in operating expenditures, resulting in significant operating leverage and growth in cash flow.

7. **Consistent growth**

The usage of infrastructure assets and hence revenue growth is largely correlated with the overall growth in the economy. By investing in strong economic regions, favoured and underpinned by strong economics, the value of the infrastructure assets should increase, along with the ability of the assets to generate increases in cash flows and hence dividends to shareholders. This makes them very attractive long-term assets.

8. **Long life span**

Given the substantial upfront capital investments required for most infrastructure assets, the time horizon for the assets in general, is very long. In the investment business this means low obsolescence and long product cycles, which reduces the long-term risk of investing.

Overall, we are partial to the infrastructure sector because we can invest in strong long-term growth businesses that provide our investors with substantial and growing cash flows. Some of our largest holdings, which will vary by client, include Canada's leading pipelines companies (oil and gas), TransCanada Corp. and Enbridge Inc., global infrastructure giants, Brookfield Infrastructure Partners and Brookfield Renewable Energy, along with one of North American's leading railway businesses, Canadian National Railway (CNR). We also own a handful of leading water businesses, including American Water Works and Xylem Inc. both are well positioned to take full advantage of the growing demand for water, coupled with water's increasing scarcity!

D. Looking Ahead

Investment expert Howard Marks once wrote that being a "contrarian" is a lonely profession. However, as investors, it is the downside that is far more damaging to our financial health than potentially missing out on a short-term opportunity. Opportunities come and go, but replacing lost capital is a difficult and time-consuming process. We continue to be very cautious. We do not want to be blind to the danger of following the madness of crowds. If we have learned anything over the past 24 years it is to be cautious when others are brimming with "irrational exuberance".

As we have repeatedly pointed out to our investors, the capital markets today, are far from normal! The major central banks around the world, by aggressively printing so much money and smacking down interest rates to such low levels, have manufactured an artificial environment for investors.

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This artificiality cannot and will not last. Noted writer and economist, Jim Grant summarized our main concern very well when he stated on CNBC, the problem is "the Fed (Federal Reserve) can change how things look, it cannot change what things are." As investors, we must invest based on what things are, not how they look! The reality is that most investment professionals know the environment is phony, but the zeitgeist is so pleasurable, the market moves and mood is so rapturous, the returns have been so irresistible, that no one wants the party to finish. Besides, the participants always believe that they will be the ones to leave first, before the bash ends!

Recently we finished reading an excellent book entitled "Economics in One Lesson" by Henry Hazlitt. We highly recommend the book. As Hazlitt points out at the outset of his book, economics is haunted by many fallacies. One of the most dangerous fallacies is the persistent tendency of people to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect the long-run effects of that policy on the overall economy and for the future.

> "Doesn't everyone know, in his personal life, that there are all sorts of indulgences delightful at the moment but disastrous in the end? Doesn't every little boy know that if he eats enough candy he will get sick? Doesn't the fellow who gets drunk know that he will wake up next morning with a ghastly stomach and a horrible head? Doesn't the dipsomaniac know that he is ruining his liver and shortening his life? Doesn't the Don Juan know that he is letting himself in for every sort of risk, from blackmail to disease? Finally, to bring it to the economic though still personal realm, do not the idler and the spendthrift know, even in the midst of their glorious fling, that they are heading for a future of debt and poverty?"[i]

But as Hazlitt points out when you enter the field of public economics, elementary truths are ignored. Even the most brilliant economists deprecate the most basic economic truths of frugality and prudence as if these laws are irrelevant when it comes to governments and central banks! Or as one esteemed economist flippantly commented, "in the long run we are all dead", as if in the long run no one cares! The tragedy today is that we are already suffering the short-term policies of yesterday today! Today is already the tomorrow, which the brilliant economists yesterday urged us to ignore! This is the real problem we are facing today. The long-term consequences of always thinking short-term, is now upon us.

For us at ROCKLINC we believe our best opportunities lie ahead of us because we are focused on the playing field, and what is actually happening, and not on the fantasy or illusion that our central banks have created for investors. At some point, debt will matter, it always does! At some point, an unsustainable social welfare system will have to be restructured. 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 wizards we have made them out to be. On that day, the party will end and the hangover will begin. Those who have remained sober, vigilant and well prepared will enjoy the brightness of the new day.

We keep focused on buying the right businesses, at the right prices operating in the best 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) sell essential products or services, and 3) 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. Owning great assets at attractive prices in these sectors, positions us for the certainty of the midnight hour!

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[i] Hazlitt, Henry. Economic in One Lesson, p. 16.