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Worth. Investing.

Strawberry Fields Forever

Investment Update

A. Third Quarter

To understand the events of the third quarter and where we stand today we need to look back five years. It was at that time that the US Federal Reserve (Fed), along with all the major central banks in the world, embarked on an audacious course of action. They commenced, what has now become, the largest expansion of money supply in the history of the world.

In the fall of 2008, the Fed began its rapid expansion of the money supply by purchasing high-risk mortgage securities from a bevy of troubled banks. The Fed decided to rescue the banks by aggressively printing money, and using this money to give to the banks, in exchange for their risky securities. In essence, the Fed transferred risk from troubled banks to themselves. Since this was done with printed money the actual cost was spread across the whole economy, by the devaluation of the currency. Money created in this manner is called “fiat money”, since it is not backed by any tangible collateral, but merely by government edict.

In recent years this money printing, (or counterfeiting), has become known, euphemistically as, quantitative easing (QE). During the last five years alone, the US money supply has increased from $800 billion to over $3.2 trillion today. Other global central banks have increased their respective money supplies by a similar factor. It is essential to understand that we have never in the history of the world witnessed a more rapid increase in global money supply. Both history and common sense bear testimony to the reality, this will not end well. As investors we must be prepared.

Let’s take a moment to revisit the activity of the Fed over the past 5 years. Figure 1 below captures the expansion of money supply by graphing the Balance Sheet of the Federal Reserve (Fed) from 2004.

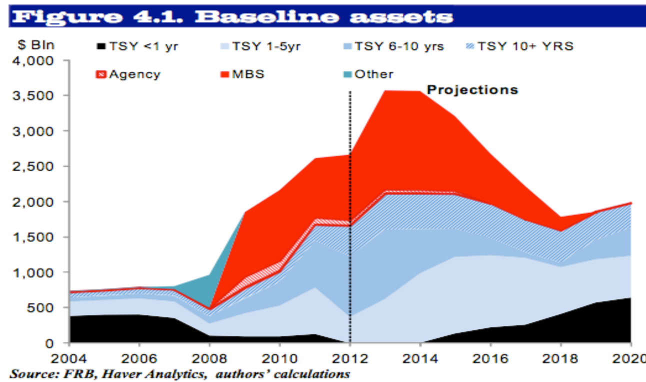
1. Five Years of Money Printing

The Fed held approximately $800 billion of Treasury notes on its balance sheet before the credit crisis hit the global markets in 2008. (Note when we refer to the balance sheet of the Fed we are also referring to the base money supply.) In late November 2008, the Fed started buying $600 billion in mortgage-backed securities and in addition several hundred billion in Treasury notes. By March 2009, it held $1.75 trillion of bank debt, mortgage-backed securities, and Treasury notes, and reached a peak of $2.1 trillion in June 2010. (This was almost of tripling of money supply in less than two years!) At that time further purchases were halted with the belief that the economy was starting to improve. Within a couple of months the economy began to falter and the printing presses were readied to begin again.

By November 2010, the Fed announced another round of QE, this time buying $600 billion of Treasury Securities, which it completed in June 2011. The effect of this new money was again short lived and another round of QE was announced on September 13, 2012. This time the Fed decided to launch a new $40 billion per month, open-ended bond purchasing program of mortgage-backed securities. Additionally, the Fed announced that it would likely maintain interest rates near zero "at least through 2015." Within three months, on December 12, 2012,

the Fed announced an increase in the amount of open-ended purchases, from $40 billion to $85

Figure 1: Federal Reserve Balance Sheet[i]



billion per month. This is the current level of money printing today, $85 billion per month, and over $1 trillion per year!

Take a moment to consider the following: the Fed is currently reproducing the total base money supply that existed in November 2008 every 9.5 months! This level of money printing is scandalous! It is unheard of in the history of finance. Anyone who thinks we live in normal or healthy economic days does not understand the extreme nature of our current monetary policy.

2. Back to the Present

On June 19, 2013, Ben Bernanke, Chairman of the Fed, announced a "tapering" of money printing was approaching, contingent upon continued positive economic data. He hinted that the Fed would scale back its bond purchases (QE) from $85 billion to $65-$75 billion a month during the September 2013 policy meeting. He also suggested at that time that the bond-buying program could wrap up by mid-2014. While Bernanke did not announce an interest rate hike, he suggested that if inflation follows a 2% target rate and unemployment decreases to 6.5%, the Fed would likely start raising rates!

On September 18, 2013, to the surprise of all the "experts" the Fed decided to hold off on any scaling back of its bond-buying program and to continue printing money at a rate of $85 billion per month, with no end in sight! Some commentators refer to this as QE to eternity! As we write this newsletter, in early October 2013, five years after the global financial crisis began all the major central banks around the world continue to expand their money supply.

One question we often receive from clients is why is the Fed along with other central banks printing so much money? The answer revolves around three items: interest rates, asset values and the funding of government deficits. Each of these three items needs to be seen within the context of the global debt crisis.

As we have pointed out to our ROCKLINC clients over the past four years, the world is faced with a massive debt bubble that is not going to go away on its own. Wishful thinking is not a viable strategy. Here are some important figures to consider in relation to a global GDP of approximately $70 trillion.

Total global debt: $225 trillion

Global bank deposits: $88 trillion

Global base money: $12 trillion

Global non-bank leverage: $135 trillion

Global bank system leverage: $76 trillion

Note we have not included the massive unfunded pension and healthcare benefits that some experts estimate at over $200 trillion for the US alone! What this number is globally when you consider the insolvency of Japan and Europe is anyone's guess. Suffice to say, it is a huge number and well beyond paying in real dollars with today's purchasing power.

With this level of debt in the global system, the only way you can keep the system from hemorrhaging or deleveraging is to do the following:

1. Lower interest rates and keep them as low as possible so debtors can continue to service their debts. This is referred to as a zero interest rate policy that in effect "steals" from savers to support debtors.
2. Boost asset values such as stocks, bonds and real estate. This is important since consumer debt is borrowed against the asset value of people's homes and securities. By forcing interest rates down, to below market rates, it encourages more people to borrow money and buy risky assets, including homes and stocks. If home prices and stock prices increase people feel wealthier and are then expected to consume more goods. This in turn helps grow the economy! This theory is referred to as bubble creation. Create another bubble to keep the existing bubble going! But as most of you know we live in a time of bubbles. First it was the dot-com bubble in 2000, then the housing bubble in 2008 and now the debt bubble in 2013. All caused to a large degree by the manipulation of interest rates and access to cheap and easy money.
3. Printing money makes it easier in the short run for governments to run large deficits so they can to continue to "stimulate" the economy (spend more than they receive). This is made easier since the government knows that their central banks will simply buy the new debt, with newly printed money! To-date the Fed has monetized (bought US debt) over 30% of all US debt. In the end this is just one big Ponzi scheme. The US government issues bonds; the Fed prints money to buy the bonds; the Fed earns interest on the bonds and then returns this interest to the Treasury as interest income!

The secret to all this is to manipulate interest rates to the lowest level as possible. The easiest way to do this is for the Fed to print money by buying as many bonds as possible. In buying up the bonds they bid up the price of bonds, this has the effect of decreasing interest rates and provides the banks and government from whom they buy the bonds with "free money". As we all know, there is no "free money" and we all pay for this by a devaluing currency and reduced purchasing power over time as inflation is created. At some point when confidence is lost there will be a currency crisis.

To be fair, the Fed has succeeded in driving up the value of most assets, particularly stocks, bonds and houses. The problem is that the current model is not sustainable and does not create true wealth. The Fed along with other major central banks cannot continue to print money and manipulate interest rates below their market clearing rates forever. Economic growth is the result of hard work, long-term capital investments, and a highly skilled and virtuous population. None of these are fostered in a debt driven consumer society that is less than productive and slothful. A culture that is content to allow its leaders to devalue its money, pushing prices up, and is content to borrow more and more because their incomes are

not keeping pace with inflation, is a culture that is in deep trouble and slowly enslaving itself to the State through its addiction to debt.

3. Lesson from the Third Quarter

This is where the third quarter of 2013 became very important for investors. It is in the third quarter that more and more investors started to learn that QE is becoming a permanent feature of our economic landscape. The Fed and the other central banks around the world have boxed themselves in and it will be very difficult for them to extricate themselves. The economy (as we have stated numerous times) is addicted to this "free money". The moment the Fed steps back from QE, interest rates will increase rapidly. This is precisely what we witnessed during the third quarter when the Fed only HINTED at tapering their purchases. Just the hint of tapering caused 10-year government bond yields to double and it forced the Fed to back off very quickly!

The problem for all the central banks around the world is if interest rates rise, bond values will drop, stock prices will drop, home values will drop, the cost of funding debt will rise substantially, and the biggest debtors, governments will experience large increases in their already unsustainable deficits.

In the third quarter, five years after the Fed commenced their reckless money printing policy, their Chairman Mr. Bernanke admitted that just the threat of reducing QE, let alone actually bringing it down, was enough to send interest rates rising, to the point in which economic growth would be severely hampered.

Finally the Fed was forced to acknowledge that tapering is going to be very difficult and that they are for the future, obligated to expand their balance sheet without end, or else, they must be willing to allow a deflationary depression to correct the gross financial imbalances that they have created once again.

4. Strawberry Fields Forever

While I am not a Beatles fan, this whole money printing exercise on the part of the global central banks and in particular the Fed reminds me of one of their songs. In 1967 the Beatles released a title written by John Lennon called "*Strawberry Fields Forever*". Although the strawberry field referred to an actual place in Lennon's youth the song had strong surreal and psychedelic overtones. The producer of the song summarized it well by saying the strawberry field was really a "hazy impressionistic dream world." The chorus to the song went as follows:

Let me take you down
Cause I'm going to Strawberry Fields
Nothing is real
And nothing to get hung about
Strawberry Fields forever

When it comes to the Fed and the other global central banks "nothing is real" anymore. We live in an imaginary world of fiat money and manipulated markets. Investors would be wise to ignore the Fed's rhetoric about ending QE and concentrate only on what the Fed actually does. We, as investors, are not interested in living in the drug induced Strawberry Field of the Fed. This is why we continue to be ultra cautious with our investments. Our focus is upon real

businesses with tangible assets. We also maintain healthy amounts of cash, so we have the flexibility to take advantage of any messy moves in the market.

We are also not perturbed in the least with the government "shut down" in the US. The current course that the US is on is delusional. Anything that brings that formerly great nation back to some financial sanity should be pursued and is in the best interests of Canadian investors. Unfortunately, the probability of any major change coming from their current leadership remains remote. We suspect any material change to their financial position will be forced upon them at a time that is not of their choosing.

B. Investing in Private Companies

Let's turn our attention to an area we believe offers some tremendous long-term potential for growth. Most investors are not aware that the total number of stocks listed in the US and in the UK on their largest exchanges, have been declining for over a decade. In fact, there are between 30-40% fewer companies listed on the exchanges (see Figures 2 and 3), within these two countries since 2000. As an investor in public companies this has caught our attention.

Figure 2: Total Listed Companies on NYSE, AMEX, and NASDAQ[ii]

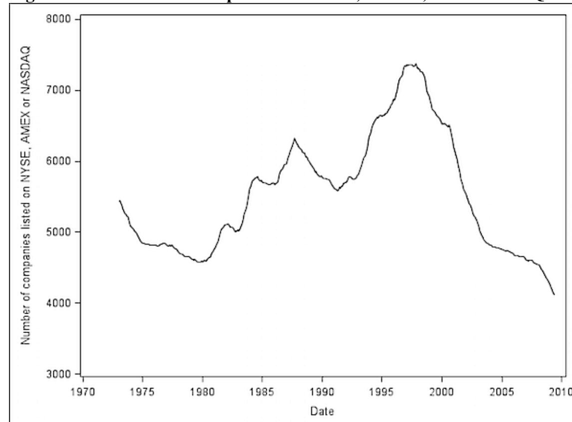
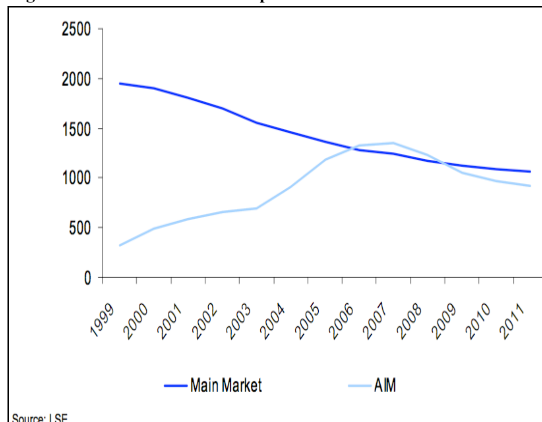


Figure 3: Total UK Listed Companies[iii]



There are a number of reasons for the decrease in publically traded businesses. First, the regulatory framework has become exceedingly onerous and expensive for companies. Second, many new companies are not as capital intensive as in the past and therefore have less financial need to go public. Third, increasing access to the debt markets at very attractive terms means companies can finance their growth with debt rather than equity. Fourth, the explosive growth of the private equity industry has provided non-public companies with access to long-term capital at attractive values. Fifth, the rise in mergers and acquisitions between public companies has led to fewer publicly listed firms.

The rapid decrease in the number of companies trading on some of the world's largest exchanges has two important implications for investors. First, the potential pool of investments for most investors looking to deploy their savings is shrinking. Fewer companies probably leads to lower returns. Second, there is a vast private market of wonderful businesses that most investors cannot invest in even if they wanted.

As a firm we have spent more time looking at this shift from public to private as well as looking at the opportunities in the private company space. In looking at the private market, we noticed several other important factors. First, the owners of small and medium sized private companies are well along in terms of their age. In Canada over 20% of all private businesses are controlled by shareholders that are 55 and over. This number has risen by 4% per year over the past decade. By the end of this decade, close to 25% of all businesses will have owners over the age of 55.[iv] The reason why this statistic is important is that as owners age, they become more interested in selling their business. This leads to the second important factor, over 30% of business owners plan to exit ownership or transfer control of their businesses, within the next five years. The numbers are very similar when you study the US market.

The growing level of private companies with their importance to the economy, coupled with the plans for many of these businesses to be sold or go through a substantial corporate restructuring, is providing opportunities for some businesses. In particular, we have been looking at companies that can either help finance the growth of private companies, and/or, help finance the transition of ownership of these firms, as they either sell to other family members or merge with other private companies. One company that has been profiting from this trend and continues to have a very bright future is Alaris Royalty Corp.

Alaris Royalty Corp. is a firm that provides capital to private, non-resource companies in return for a long-term royalty stream from the company. The management at Alaris is capitalizing on the increasing demand for capital in the private company space, as more and more private companies, do not want to go public and are looking for expansion or transitional capital.

Key reasons to own Alaris Royalty Corp.

1. Strong management ownership in the company and good corporate governance. Currently the directors and officers of the company own approximately 9% of the firm. We like companies that are managed by owners/operators, who eat their own cooking.

2. Large demand for capital in the private market. The best companies do not want to go public anymore if they can avoid it. Borrowing from Alaris in order to grow their business or transfer ownership within the company is often a much more attractive alternative.

3. Low cost of capital. Alaris, given their high quality management coupled with their exceptional track record, is able to raise equity capital at very attractive prices. They can then loan this money out through innovative royalty structures at a high spread. For example, their cost of equity is approximately 8% and they can create royalties that generate on average 15-16%.

4. Increasing scale and safety as the company grows. As the business grows it continues to diversify its royalty streams and reduce any concentration risk it might have on any one business or industry.

5. Strong free cash flow that is paid out in dividends. Given their lucrative financial model that gives them tremendous operating leverage, the company produces substantial and growing levels of free cash flow. The stated goal of the company is to pay out 80% of its earnings in dividends.

We have built a fairly substantial position in Alaris Royalty across most of our client portfolios. Currently the stock is not inexpensive and we would look to add to our position during weak

market conditions. There is another firm we are currently researching that might provide us another investment vehicle to take advantage of the growing opportunities in the private market.

C. Looking Ahead

With the risk of sounding like a broken record, let me point out the obvious, there are some major challenges facing the global economy. We are doing our best to both prepare for these challenges, and invest through them. As we have explained in this newsletter, as well as previous newsletters, the world is awash in debt. Living beyond our means will come back to bite us. The tension in Europe, Japan and now the US is palpable. Printing money (quantitative easing), zero real interest rates, growing unfunded liabilities, aging demographics and less than honest accounting throughout our global financial system, will result in some major price swings in the days ahead. We are positioned to take advantage of these swings.

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 and third quarters and have increased exposure across a range of industry sectors. This not only dampens portfolio volatility, it provides you with a broader range of growth opportunities. Industries in which we are consciously broadening our exposure include, water (discussed in our second quarter newsletter), agriculture, technology and select financial companies such as Alaris Royalty, which we just highlighted.

The area of greatest interest to us, and our investors, continues to be the precious metals sector. The price swings throughout the second and third quarters have been unbelievable. We have added to some positions where appropriate but are keeping our allocations in this sector fairly tight. All of the fundamentals we have discussed in this newsletter as well as others, 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. The businesses we own in this sector are elite companies with fortress like balance sheets. Given today's valuations and the ongoing easy monetary policies around the world the upside on these companies is massive. Time and patience is on the side of owning these great businesses.

We continue to arrange meetings with all our clients in order to update you on your portfolio. We appreciate your support and confidence in our firm. We trust each of you had a wonderful summer and are currently enjoying the beautiful autumn season.

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[i] David Greenlaw, James D. Hamilton, Peter Hooper, Frederic S. Mishkin. Crunch Time: Fiscal Crises and the Role of Monetary Policy. U.S. Monetary Policy Forum, New York City, February 22, 2013. Revised July 29, 2013. Page 70.

[ii] TopForeignStocks.com. Total Number of U.S. Listed Stocks vs. Mutual Funds – Which One is Higher? http://topforeignstocks.com/2011/05/28/total-number-of-us-listed-stocks-vs-mutual-funds-which-one-is-higher/. May 28, 2011.

[iii] John Kay. The Kay review of UK equity markets and long-term decision making: final report. The Department for Business, Innovation and Skills. UK. July 23, 2012. Page 25.

[iv] Benjamin Tal. “Inadequate Business Succession Planning”, CIBC Economics, November 13, 2012.