Patiently Panning for Gold

A. Market Update – Third Quarter Review

A growing US economy has propelled US stocks and bond yields higher this quarter, helping US equities lead the global pack by a wide margin. In September, US consumer confidence hit its highest level since 2000, while the monthly average initial jobless claims, fell to their lowest level since 1969. Even wage growth rose, reaching its highest level since the financial crisis in 2008/2009. The increase in wages helped retail sales increase by over 7% year over year. Also, the National Federation of Independent Business's survey showed that small businesses were the most optimistic they've been since the survey began in 1974. Given this backdrop, it's not surprising that US equities continued to advance throughout the quarter.

At the start of the year, market forecasters thought there was only a 20% probability that, by now, the Federal Reserve (Fed) would have raised interest rates three times this year. Even at the start of July, markets believed there was a 40% chance that the Fed wouldn't increase rates again in the third quarter. But the Fed continued to surprise most market commentators and raised rates again in late September, with Treasury yields edging higher over the quarter.

Emerging market (EM) equities have been weighed down by a number of factors. These include a slowdown in the pace of Chinese credit growth, fears over the vulnerability of some economies to tighter US monetary policy (increasing interest rates in the US) and concerns about the potential impact of global trade tensions, as President Trump attempts to re-order global trading arrangements. With China now facing the external headwind of US tariffs, expect EM countries and their equity markets to be adversely affected and as a group, turn in negative investment returns for the year!

Since EM economies are the most reliant on external funding, they are finding the tightening in US monetary policy to be very challenging. As the Fed continues to raise rates and shrink its balance sheet (the reverse of printing money), EM countries with large dollar-denominated debts and significant current account or fiscal deficits will continue to struggle. Higher oil prices will only exacerbate an already difficult position for those EM economies that are large oil importers, particularly those whose currencies have fallen sharply, further increasing the cost of imports in local currency terms. The tightening in interest rates, that some economies have been forced into to defend their currencies and control inflation, will spill over to the global economy and slow global growth.

UK equities have been weighed down by fears of a no-deal Brexit, and the poor political leadership in the UK, that continues to waffle on just about everything! It is possible that investors view deadlock within the Conservative Party, as increasing the risk of a Labour government. Without a doubt, the emergence of a rabid socialist government in the UK would be terrible for UK equities, and for the direction of the UK in general. Haven't we seen this movie before? Is there another Margaret Thatcher in the wings? The concern raised by a Labour government only serves to complicate the outlook for UK investors. This makes the outlook for UK equities particularly hard to predict, even if you knew the outcome of the Brexit negotiations. This is why we try to filter out the political noise and continue to focus on companies that

regardless of the political gyrations, will do what they do best, manufacture products and produce services of high value to growing markets.

While the US economy is humming at a near record pace, the Eurozone is in the doldrums. Since the beginning of the year, there has been a material weakening in the Eurozone Manufacturing New Export Orders Survey. Most of this weakness appears to be coming from a sharp slowdown in exports to China. As the Chinese ease monetary and fiscal policy to support higher domestic demand, pressure could ease. But with China getting more and more entangled in a trading war with the US, it's hard not to envision tougher economic conditions for the Eurozone. We remain very cautious. The main risk is that weaker exports to China and the EM markets, combined with higher oil prices, will hurt domestic spending in Europe. Consumer confidence has fallen steadily since the start of the year, with a particularly sharp decline in France. Italian political developments, and the squabbling over the new budget, could also prove a source of volatility over the coming quarter. As we have stated many times, the Eurozone is not healthy on any level, and the banking system, regardless of what the European Central Bank says, is very weak at best!

The most obvious near-term risk to the global economy is the potential for a further escalation in trade tariffs, emanating from the US, and subsequent retaliations by other countries. So far the US is imposing tariffs on about $250 Billion of imports from China, and China has retaliated with tariffs on about $110 Billion of US exports to China. The tariff rate is scheduled to increase in January 2019, if a deal cannot be reached, and an escalation to imposing tariffs on all of China's exports to the US has been threatened. The worst case scenario could prove to dampen global growth and increase inflation. To-date, the pundits have overstated the negatives of trade negotiations, and so far there has not been a significant negative impact! The reality is that the global trading arrangements have been far from "free", and much of what President Trump is advancing is for a more open and free global trading system, that in the end, will be better for the global economy. But make no mistake about it, this re-ordering will not be easy. The economic and political realities will be felt by countries like China, who have hidden behind unfair trading tariffs, set by the World Trade Organization, and stolen trillions of dollars in intellectual property, over the past two decades.

Fixed income returns have been pretty uninspiring and largely negative, with high yield credit outperforming government bonds. Against a backdrop of very strong growth, rising inflation and rising interest rates in the US, it is notable that, while unexciting, fixed income returns haven't been as bad as some might have predicted. Year to date, EM debt has been the clear underperformer, although it should be noted that the worst performing EM credits make up a small part of the index. Looking ahead, we believe investors should focus on liquidity and quality within fixed income markets, and be aware of elevated leverage in US and Canadian investment grade credit. We are keeping the duration of your bond portfolios short, with a few of avoiding any losses on our bonds, and reinvesting maturing bonds at ever increasing yields!

Overall, global growth remains positive but less synchronised than last year. For now, the US stands out as the clear leader in terms of growth, given its pro-business, pro-growth agenda. In the near term, the main risk appears to be that the trade conflict will escalate and weigh on business and consumer sentiment. So far there are some signs that this may be happening outside the US, but the US itself has remained resilient with money pouring back into both its currency and economy. The extent to which the US and the rest of the world can withstand the impact of the latest round of tariffs, and the rebalancing of the global trading system, will determine much of the volatility and opportunity moving forward.

In the medium term, the primary risk seems to be that the US economy, while currently booming, could be in the later stages of the business cycle, and no recovery lasts forever. The combination of these near-term and medium-term risks, along with the large and unsustainable budget deficits, argue for turning the dial down in our portfolios, to reflect the fact that while growth currently remains healthy, the risks are gradually rising.

North American Equity Market Statistics

During the third quarter the Canadian equity market, S&P/TSX (Total Return – dividends reinvested) decreased by 0.6 and year-to-date increased by 1.4%. The S&P/TSX, has been one of the worst performing equity markets in the developed world over the past 10 years. Despite the underperformance of the broad basket of Canadian equities, ROCKLINC has managed to generate positive returns over the past year and for longer periods, staying ahead of the overall market index. We have managed to do this by avoiding many of the weaker performing stocks and minimizing our exposure to some of the underperforming sectors. During the third quarter our basket of Canadian companies underperformed the index with our underweighting in “health care stocks”, otherwise known as “cannabis” and our lower than index weighting in the banks. Our overweight in the gold and silver royalty companies was also a significant drag during the quarter. Despite a weak third quarter performance on the part of a number of our Canadian equities, the businesses themselves turned in strong financial performances and continue to make steady progress.

In terms of the S&P/TSX, the sectors ranked from best performing sectors to the worst in the third quarter were: Healthcare +31.2, Industrials +5.2%, Financial +3.0%, Information Technology +2.9%, Real Estate +2.8%, Telecom +1.2%, Consumer Staples –1.3%, Utilities -2.9%, Energy -6.6%, Consumer Discretionary -8.4% and Materials -13.2%.

Pertinent market action during the third quarter of 2018 and during the last 12 months is captured in the following table.

	Sept. 30, 2017	June 30, 2018	Sept. 30, 2018	3 Month	1 Year Return
CAD/USD	$.8061	$.7630	$0.7744	+1.5 %	-3.9%
Oil WTI (US $)	$51.64	$74.13	$73.56	-.77%	+42.4%
Gold (US $)	$1,278.50	$1,250.45	$1,188.38	-4.9%	-7.1%
Silver (US $)	$16.65	$16.06	$14.61	-9.0%	-12.3%
S&P/TSX	15,635	16,277	16,073	-1.25%	+2.8%
S&P 500	2,519	2,718	2,914	+7.2%	+15.7 %
Cdn 10 yr	2.10%	2.17%	2.43%	+26 bps	+33 bps
US 10 yr	2.33%	2.85%	3.06%	+21bps	+73bps

A quick note on precious metals. Without making any predictions as to the exact value of gold and silver it is fair to say that precious metals are quite inexpensive (based on physical demand, supply and production costs) and are well positioned to advance looking forward. Given the increasing level of inflation, the record levels of consumer, corporate and government debt, and the increasing trade concerns around the world, precious metals should be bid higher in the fourth quarter and next year. We continue to own the world’s leading royalty and streaming companies, in the precious metals space. If the markets do the “wild thing” on the downside, these

companies should do the “wild thing” on the upside! Because they are all growth companies, they should continue to create long-term value, while protecting us from extreme volatility.

The four royalty and streaming companies our clients have exposure to are Franco-Nevada, Royal Gold, Wheaton Precious Metals and Sandstorm Gold. Each one of these companies continue to generate record performance, despite price weakness in the underlying precious metals. In fact, during the third quarter, on average these four companies decreased in value by approximately 17%. While this can be frustrating for investors, it is more valuable to focus on the businesses and not the stock prices. In fact, the best course of action, is to turn investor frustration into opportunity, by adding to positions at these phenomenal prices.

The table above (page 3), continues to point to the reality of increasing interest rates. The key question is: what level of interest rates will start to weigh meaningfully on economic activity? Though this question is difficult to assess in real time, we are increasingly monitoring areas of the economy that have seen an increase in leverage. We are particularly mindful of the fact that leverage in the corporate sector is high by historic standards and the corporate debt service ratio is rising. This could be the primary channel by which higher interest rates eventually pose a risk to the US economy, and by extension, to the global economy. At the time of writing, early in October, interest rates have continued their advances higher, putting downward pressure on both stocks and bonds. If this trend continues, the stock market will succumb to this pressure and provide us much better prices to add to our favourite stocks!

During the third quarter, the price of bonds continued to drop, with yields on both the 10-year government bonds in Canada and the US increasing by 26 and 21 basis points, respectively. Year over year yields continue to climb. This has put significant downward pressure on the value of bonds. When it comes to ROCKLINC, our investors are largely sheltered from the volatility in bond values, since we keep investing in quality bonds with very short durations!

We continue to watch the central banks, and in particular the US Federal Reserve to see how aggressive they will be in lifting interest rates. For the time being, we will only invest in short-term (less than 4 years, with most under 2 years) quality bonds for three reasons. First, they help dampen volatility in client portfolios. Second, all the fixed income (bonds) positions we own are liquid and can be sold quickly in the event the world’s stock markets sell off, and we need some cash to take advantage of cheap equity prices! Third, as bonds mature, we are able to roll them over into bonds offering higher yields. **The bottom line is that the level of debt around the world cannot withstand a major move in rates, without creating a serious recession/depression in the global economy.**

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate, across all our accounts, they were up 0.6% during the third quarter of 2018 and up 5.7% during the last 12 months (period ending September 30, 2017). Our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 8% and 8% respectively. Returns are after all fees, and are based on an asset mix of approximately 68% invested in equities, with the remainder invested in short-term deposit accounts, bonds and preferred shares. This asset mix has varied over the past five years but in general we have averaged approximately 65% invested in equities. Currently we are running just above 70% in equities, at the end of the third quarter. Please note that the performance we are

discussing is our aggregate performance across all our accounts. Each client's portfolio is unique, and performance will vary, based on your risk tolerance and your specific asset allocation.

When we dig further into our numbers, we find that our basket of equities increased by 0.7% during the third quarter, and by approximately 8% during the past 12 months. Our equities have been compounding by approximately 12% per year over the past 5 years. It is interesting to point out that there has been a significant difference in performance between Canadian and US equities. Over the past five years, our Canadian equities have been compounding at 9% per year, while our US equities have been growing at 18% per year! This points to the both the greater investment opportunities outside Canada and the red hot US market. We will continue to allocate capital into global businesses and glean the benefit of global growth and diversification in your portfolios. Given the conservative nature of your portfolios, we are pleased with our progress, but are working hard to grow your portfolios even faster in the years ahead.

For the time being, as long as the market is volatile, our focus is on first, selectively adding new companies as we come across new opportunities, second, pruning underperforming businesses and third, taking full advantage of market swings that provide us with the opportunity to buy one of our exceptional companies at a great price! Warren Buffett calls this swinging at "fat pitches". In the investing world you cannot strike out by not swinging, so wait for the best pitch rather than reaching for the tough ones!

The first three quarters of 2018 have been filled with plenty of excitement and riveting headlines. We have been able to hold our own and add a little value in the face of a volatile and sideways Canadian market. We expect the challenges to remain for the foreseeable future and will continue to be vigilant in protecting your capital. The best way for us to protect and grow your nest egg is to ferret out new opportunities, to invest your capital. One such opportunity is Pentair plc. Over the past year we have been building a significant position in this business.

C. Company Update - PENTAIR

No one can dispute the statement that water is one of the most important commodities for sustaining life on earth. It is also true to say that fresh clean water is in short global supply! From an investment perspective, whenever you can find an essential commodity in short supply, there is an opportunity to make some money! Businesses that provide for the transportation, filtering, purifying and pumping of water will enjoy long-term tailwinds as the global population grows and water scarcity increases. Pentair is a great example of a business that offers products and solutions, often 'behind the scenes', handling necessary, everyday water supply and disposal needs.

Pentair offers a wide variety of innovative and high-performance products, leveraging both its distribution channels and reputation for quality. With immense product depth and knowledge, the Company offers the industry's broadest portfolio of pumps and valves, having judiciously shaped its portfolio over the past decade to focus on its core competencies of water purification. In addition, the Company's ability to generate substantial levels of free cash puts it in a strong position to take advantage of a fragmented but consolidating competitive landscape. 'Tucking-in'

small but strategic players to complement or solidify its existing portfolio of offerings should create substantial wealth for their shareholders.

Pentair operates through 3 main segments: Filtration Solutions, Flow Technologies and Aquatic Systems.

Filtration Solutions - Designs and manufactures solutions for filtration and separation in the agricultural, food & beverage and water supply/treatment industries, among others. Pentair offers advanced filtration solutions, membrane technology products and instrumentation to aid customers in offering clean, filtered water.

Flow Technologies - Engaged in water disposal, process and control. For example, Pentair aids municipalities, helping them to face the challenges with regards to flood control, storm water management and dredging, by providing products such as pumps, pressure boosters and quality control instruments.

Aquatic Systems - Pentair has a market-leading position in the aquaculture segment, commanding superior brand recognition. Many pools, both residential and commercial, use Pentair products for pumps, valves and filtration. The Company is able to benefit from the growing trend of automation and connected pool technology that will further solidify customer relationships.

Earlier this year, Pentair divested of its large Electrical business through a tax-free spin-off into a newly publicly traded company called *nVent*. These spin-off transactions typically 'unlock' value as shareholders value each pure-play operating business higher on their own rather than when combined. As such, shareholders of Pentair prior to the spin-off now own shares of Pentair (a pure-play water company) and nVent (a manufacturer of electrical components and thermal management products).

nVent's products and components are typically in the 'bones' of many commercial and industrial buildings. The Company designs and manufactures products that guard and protect some of the world's most sensitive electrical and electronic equipment, commanding a large global install base spanning a wide range of industries such as communications, energy, industrial, infrastructure, medical and defense.

For example, businesses that operate large data centers need specific wiring and electrical enclosures to accommodate for the increased heat generated by the vast number of computers operating as servers. Many industrial and commercial buildings require fire-rated wiring cables and power distribution products that connect and protect electrical and mechanical systems. With a newly installed motivated management team and a strong market position with rich brand histories, nVent is well positioned to achieve its stated mission of connecting and protecting their customers with creative and value-added electrical solutions.

From an investment perspective, we believe both Pentair and nVent are well positioned to benefit from long-term secular tailwinds in their respective industries, providing critical products and services needed to deliver clean water and protect electrical components across a wide range of industries. With tremendous brand awareness and an unrivaled product portfolio in key segments,

Pentair and nVent are preeminent names in the water and electrical spaces, respectively. We plan to continue building meaningful positions in these two businesses.

D. Moving Forward – Patiently Panning for Gold

Our goal is to keep our eyes fixed on the fundamentals of the businesses we are investing in, on your behalf. **We will do our best to take advantage of any moves in the market, which might be larger and more violent than what we have been accustomed to recently.** As investors, volatility and turbulence are our friends and we will use them to your advantage. The investment team at Rocklinc is working hard to make sure our existing companies are performing as expected, and panning for new companies that we can add to your portfolios. We like to refer to our research as "panning for gold"! It is a good picture of what we do each day.

According to one expert[i] there are typically three mistakes prospectors make when panning for gold. These three mistakes correlate well to the investment industry! The three most common mistakes are, first, not having the right gear, second, heading out with unrealistic expectations and third, sifting away the small gold flakes! When considering panning for great investments we need to keep these three mistakes uppermost in our minds. First, what is the best gear when looking for great investments? You must have talented hard working people with the right investment philosophy or grid by which to evaluate businesses. Second, what are reasonable expectations for your investment returns? Investors know that returns only come after a reasonable period of time, and by investing in great businesses at the right price. Third, don't let any valuable businesses (flakes of gold) slip away. The investing business is a tough one and all the little things matter! As with life in general, the little things add up to become big things!

Our basic strategy, continues to be summarized in the following six points!

1. Diversify across asset classes, sectors and geographic regions. At the current time we are focusing on eight sectors. These are infrastructure, financial, technology, manufacturing, precious metals, healthcare, agriculture and water.

2. Invest in businesses with strong balance sheets, backed by hard and tangible assets.

3. Invest in firms that produce essential products and services, in growing industries, with long-term secular growth trends well established. Pentair plc and nVent which we highlighted in this newsletter, are excellent examples.

4. Avoid/minimize highly leveraged financialized firms that have incomprehensible balance sheets, loaded with risky derivatives.

5. Maintain liquidity in our portfolios, in order to take advantage of significant moves in the stock market. Cash is not trash when the markets get crazy!

6. Stay optimistic and opportunistic without being naive to the risks all around us. **Investing in turbulent times can be rewarding, with the right investment philosophy and prudent execution.**

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

Worth.Investing.

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[i] www.luckypanner.com