

Today's Notes:

1. Discovery, Contraction and Commodities

1. DISCOVERY, CONTRACTION AND COMMODITIES

Last weekend I participated in an interview with Michael Levy (Money Talks Show in western Canada) on CKNW radio. It was a wide ranging interview, one of the best in my view. We discussed many issues including the recovery, the US bank bailout, Canada's exposure and the now familiar notion of Quantitative Easing. Subsequently over 700 new readers registered for Morning Notes. That fact tells an important story. People everywhere are very afraid and, more important, they are in the dark.

We think that the American government is utilizing this widespread ignorance (ignorance in the sense of not understanding complexity of events and possible outcomes) to assume significant power from its citizens. For example the power to choose your own health care provider. There is no doubt that wealth redistribution is the new order of the day, fair or not.

But today I want to focus on Discovery Investing and the commodity sector. As you may know Morning Notes has traditionally focused on this topic. During the bull market of 2003 through July 2008 commodities soared, pushed initially by real demand from the BRIC countries. Toward the end of the Bull they were pushed by speculation, no doubt, and finally liquidated en mass. Bernice Cohen (*The Edge of Chaos*, a must read) details 4 American boom / bust crises through the crash of 1987. She notes the inevitable dénouement of each,

“Again the debt deflation takes a predictable form.

The massive inflation of the boom is followed by the crisis of the crash and demands for cash become overwhelming. This triggers the liquidation a massive sell-off in financial and other assets to convert everything as quickly as possible into cash. ... no matter how inadequate borrowers and lenders must agree on the reckoning.

Every debt must be settled.

Loans will either be repaid and the borrower suffers, or the borrower will default and the lender bears the loss. In the scramble to repay debt property, commodities, precious metals, antiques, art objects, all will be sold, even at rock bottom prices ... The onset of the deep depression actually marks the dawning of the new credit cycle and the turning point ...”

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At present the debts are not now being settled, just reallocated to US taxpayers. I wish I had taken on more debt!

How does Discovery Investing fit into this framework?

In Discovery Investing we search for “game-changing” discoveries using a ten point grid to parse companies and technologies that seem most promising. Commodities such as rare earth elements and gold, promising medical modalities, new water technologies, development of bio-fuels and other discoveries are all part of the package. One such discovery could change the world, as well as your fortunes. Ponder for a moment the potential of a few discoveries:

- 1) A cure or effective treatment for cancer.
- 2) Stem cell technology which successfully treats Lou Gehrig’s disease or Multiple Sclerosis.
- 3) Economic lithium-ion battery technology using nanoparticles,
- 4) Nuclear reactor breeder technology that consumes all the waste and emits no greenhouse gasses.
- 5) A new water technology / source for the thirsty states of the Western US.
- 6) Economic, clean coal technology that can transform lignite coal into gasoline.

These are a few of the discovery possibilities I seek. You may have your own biases in this regard. The possibilities are unlimited. Investment is critical. The commodity sector is also wide open to Discovery Investing. The rationale is that in the long term wealth is created in every significant commodity discovery.

Given Washington’s historical and new found proclivity to print fiat dollars and increase US deficits, America badly needs wealth creating discoveries. D.I. is vastly more important and powerful today at solving some of our pressing problems (global warming is not one of these). All these can be “game changers” for the global economy and for you personally. In view of the global quality of life cycle, which believe me has not been derailed one iota; I submit that these discoveries are increasingly necessary. Resources (water for example) are most finite. In 1953 King Hubbert was prescient beyond his wildest imagination. It is not only carbon based energy availability that has peaked.

Discovery Investing is based on two important precepts of **diversification and analysis**. Most discovery companies are in the formative part of their life cycle where risk is highest. The Discovery Investor (D.I.) must also assume a significant equity position early and hold it to be successful. Not everyone can do this. How many times have I heard the plaintiff cry, “*I didn’t own enough*” or “*I sold it all too soon?*” Finally, the process of Discovery Investing requires a lifelong inquisitiveness and love of human progress in this hard world. In this respect it is more relevant than any social investing discipline. It requires courage and patience. It also requires the behavioral tenacity to absorb losses – for surely more losses than successes will occur.

The selling discipline in Discovery Investing is simple, personal and powerful. I **always** take profits when I have doubled my initial investment. I sell half the position and allow the remaining position to stay the course. I do not take tax considerations into account. Waiting

for long term capital gains treatment is, as Dennis Gartman suggests, “a mugs game.” I usually try to double a position on a failed result (such as a blank drill result or poor clinical trial result). Western Silver and ImClone are great examples of billion dollar discovery successes after initial failures. ImClone fell from \$60 to \$7.50 before its clinical success and a \$6.5 billion merger with Bristol Myers.

Discovery Investing is not always the expedient wealth creation mechanism however. ImClone was formed in 1984 and taken out in 2008 – 24 years.

I never, ever tell anyone when or how to sell their holdings. You must decide the issue. That it is a matter of personal preference.

And now as we are entangled in this tangled and multifaceted financial trap of our own making, what of Discovery? We think it is even more crucial today. We pray that authorities in Canada and the US will agree and not reign in the ability to make such discoveries. Yesterday President Obama suggested that he will tax oil and gas manufacturers for carbon emissions. Understandably, this is an attempt to gouge these vitally important economic players for the government’s wealth redistribution. It will vastly increase the cost of energy in this country at a time when full scale build out of alternatives is unlikely for a decade or two.

Congress (the House) wants to halt all mining in this country with an 8% gross royalty on ALL new mines. I am told that Barrack and Newmont support this legislation. Discovery in all areas continues to be crucial to our well-being. Discovery north of the 48th parallel is likely to be much more fruitful. We also think that the Mexican situation will resolve itself. Mexico urgently needs new oil extraction discoveries as well as new mining ventures to support its wobbly economy.

What of commodities? We watch the commodity cycle because an upturn in commodities will be one of the signals for the turning point in this **Great Contraction**. We have seen copper, oil and the softs all strengthen in the New Year.

Below I show the Reuters Jeffries Commodity Index (right) and the Morgan Stanley equity commodity index. The commodity stocks (in the Morgan Stanley index. left) seemed to have made a bottom. We think this is very good news, a “Green Shoot.”



In spite of much further decline in the broad indexes the Reuters index also has made a bottom. This is quite likely a result of the massive liquidation discussed by Bernice Cohen above. She said,

“In the scramble to repay debt property, commodities, precious metals, antiques, art objects, all will be sold, even at rock bottom prices ... The onset of the deep depression actually marks the dawning of the new credit cycle and the turning point ...”

This liquidation occurred between July 13, 2008 and December 1, 2008 as indicated in the graphs shown above. If this were a normal recession we would be inclined to call the bottom based upon the commodity indexes above. However there is still some pain to come. Nevertheless most of the bad news has now been discounted in the commodity sector. Add these thoughts to my Discovery hypothesis:

Great discoveries create great wealth and the QOL independent of the economic cycle.

This is probably not an economic turning point however. The Great Contraction still has legs. But using my Ten Point Grid may pay handsome dividends going forward. Many of these Discovery stocks are extremely cheap. They have been ravished in the past 9 months by an unmitigated, global liquidation of assets to pay down the unmanageable debt overhang.

Secretary Paulson initiated this asset liquidation and with it the US dollar bull market last July. The current administration, in the person of Secretary Geithner, ended it Wednesday under pressure from China with a public death-wish for the US dollar as the world's reserve currency.

We will see an economic recovery eventually; perhaps this year, perhaps next. If you feel confident you should become positioned now **in sustainable discovery investments** in the commodity sector (or other sectors discussed above) and particularly in the precious metals sub sector. I think you will fare well.

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