Aspera Review

Intelligent, Independent Investment Management

First Quarter 2009 – Finally A Buying Opportunity

Aspera Financial, LLC is an independent registered investment advisor.

Aspera offers independent fee-only investment management and advisory services throughout the Triangle area and nationwide.

Every client portfolio is separately managed.

The securities and strategies discussed in this Bulletin may not apply to every client portfolio.

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I was supposed to be running my first ultra marathon (50+ miles) this weekend, but the Bell household managed to come down with a pretty bad cold in the past few days, so rather than an endurance run, I've managed to do an endurance write. For those of you who enjoy these write-ups, you're in luck. For anyone who doesn't read them, this one is no longer than any other.

This past quarter provided another great example as to why I urge you not to pay too much attention to the markets. There could be serious health consequences – vertigo, ADHD, insomnia, indigestion, and whiplash, to name just a few. Although the U.S. stock market fell 11.5% for the quarter, it was marked by two very distinct periods. The first lasted until March 9th and produced a dramatic decline of 25%. The second covered just the last few weeks of the quarter and generated a strong positive return of 17%. The performance during either one of these short time periods would constitute an eventful year.

The first period was marked by a deteriorating global economy, poor fourth quarter 2008 earnings announcements and earnings guidance from virtually every company, heightened concern about the health and viability of the banking system, and poorly-received Federal Reserve schemes and government bailouts. We also saw a record number of news stories on how to survive the coming Depression. Favorite tips included:

- getting gastric bypass surgery so you'll eat less, regardless of your weight.
- intentionally committing a crime to be sent to prison where you'll be fed, clothed, and housed for free.
- renting out a room in your house to one of the few remaining profitable businesses, such as a meth lab or a state unemployment insurance office.
- searching your couch for spare change to buy AIG and get in on the bailout.

I even saw Amway advertising on national TV. That can't be good. The onslaught of bad news again increased the sense of foreboding in the market and led to a steady decline in the market of 25% in nine short weeks.

So what happened from March 9th forward? Why the reversal? As I had mentioned previously, all that was really necessary to get a strong rally started was a decrease in the magnitude and frequency of bad news, and we saw that. There were a number of other factors as well. The market was oversold on a near-term basis and due for at least a bounce, sentiment

was atrocious (a good contrary indicator), valuation was finally quite attractive, there was a great deal of cash sitting on the sidelines, and a few economic indicators offered some hint of a possible bottoming in the real estate market. In addition, some hope surfaced that the (deeply flawed) Treasury plan for getting toxic assets off of bank balance sheets might actually help.

Once the market started to move, it was no surprise that more people and institutions piled in. No one wants to be left behind if this proves to be the ultimate bottom. Furthermore, advisors and institutions who release their quarterly investment holdings wanted to show that they were participating in the rally, so many of them were likely buying as the end of the quarter rolled around (the industry refers to this as window dressing).

The volatility in all markets has been simply amazing the past six months. Although most fear volatility and equate it to risk, I view it as a friend (I know. I need to get out more.) It has provided us with some terrific opportunities to build long-term positions in a variety of investments. It also has allowed us to take advantage of a number of short-term overreactions, on both the buy and sell side. The amount of trading I've done is certainly much greater than it would be in calmer times, but most of this activity has been nicely profitable.

First Quarter Results

The past few months have been exhausting, but at least the exhaustion paid off. I'm happy to report that despite a 11.5% decline in the market, all Aspera accounts registered gains during the first quarter, ranging from 1-8%. This was a solid quarter in a number of respects. In general, both our long-term and short-term positions performed well in a tough environment. In addition, most of the trading that occurred during the quarter was fairly well-timed. Interestingly, despite a healthy decline in the market, the best performing accounts were the most aggressive accounts.

The best move made during the quarter was the boosting of "risk" (any investment but cash/money market) exposure that began in mid-February and accelerated through mid-March. In fact, my most active day of buying this past quarter was on March 9th, the date of the most recent low in the market. By the time the market had bottomed, most accounts were nearly fully invested for the first time since I've managed them.

We were also fortunate to benefit from some strong performance in a number of securities. Our gold positions performed particularly well. Although the metal itself was only up 4.4% for the quarter (still much better than the stock market), our gold stock positions registered some impressive gains. The best performers were the junior miners (small gold mining companies). Of particular note, NGD rose 31%, GSS rose 46%, XRA increased 66%, and UXG put up a tremendous 124% gain in the quarter. Of course, these results are not likely to be sustained, and we should expect to see some pullback in these names.

Energy was another solid performing sector for us. Our Petrobras (PBR) position gained 24% for the quarter. Our Chesapeake Energy (CHK), Nabors (NBR), and Kinder Morgan (KMP) positions also registered nice gains.

The other decent performer last quarter was the technology sector which managed to eke out a modest gain. Our exposure to QLD (a double long position heavily weighted towards tech) helped us keep pace, as did a number of individual tech names.

Equally helpful was avoiding some of the weakest sectors. Real estate and financials were the worst performers, with many of these names falling more than 25%. On a net basis (offsetting long and short positions), we were close to a 0% weighting in this area last quarter and were able to avoid the carnage.

If there was one disappointment in the quarter it would have to be the performance of a couple of higher risk companies owned in more aggressive accounts. Specifically, EGLE and DRYS have been laggards. These firms own huge dry bulk ships that transport many dry commodities around the world. Not surprisingly, this industry has suffered greatly with the global downturn. Furthermore, these two stocks

have a hefty amount of debt which puts each at risk if they're unable to renegotiate debt terms or if the shipping market doesn't pick up in the next 18 months. These two stocks are what I call binomial stocks. They will be eventual home runs, or they will fail. For this reason, they are only owned in more aggressive accounts and in relatively small amounts.

I've added to these names over the past few months in anticipation that an eventual rebound in the market and return of risk appetite would vault these names higher, given their financial leverage and leverage to the global economy. That hasn't happened to the degree I had expected during this most recent rally. At the moment, I'm inclined to be patient and see how things progress. Plenty of capacity is being reduced in the industry (new orders are being cancelled and older ships are being retired and sold for scrap). These two companies own a solid fleet of relatively young ships and should eventually benefit from the capacity rationalization underway. The key issue is whether they can continue to service their debt long enough for industry fundamentals to improve.

Outlook

We moved into risk assets during February and March because valuation was compelling relative to the economic and earnings risks we faced. The market has now rallied over 20% since the lows of March 9th. As I wrote in the March 23rd Bulletin:

> …I plan to gradually decrease our market exposure should the rally continue. We own a number of core long-term positions that will not be sold any time soon, so there is certainly a limit as to how low our exposure will drop, but my bias is now once again towards selling. We may soon be initiating some new short positions as well, particularly in the finance sector, if the rally continues.

This is precisely what I've been doing of late. Given the rise in the market, the compelling valuation that existed a few weeks ago is now much less tempting. We began reducing our risk exposure on March 19th and have continued to gradually reduce exposure since then as the market has moved higher. Recognizing that no one knows how far the rally will go, our selling has been and will be gradual. We also initiated some short positions (a bet that a security will fall in price), specifically in the financial and solar space. We've now unwound a good deal of the exposure we had put on in February and March. Should the market keep moving higher in the near-term, I would anticipate further selling and shorting.

There are two key reasons for the selling. The first one has already been mentioned – valuation is no longer compelling. The second reason is that the ***sustainable*** solid recovery that many now seem to be expecting later this year is unlikely to happen. I've cautioned that we would see some improvement (or less deterioration) in many economic indicators as the trillions in stimulus start to have some impact, and we've already begun to see some very modest evidence of that. That improvement and the anticipation of further improvement are key factors driving this current rally. However, any improvement we do eventually experience will largely be artificial and unsustainable. This is due to the gravity of the national and global imbalances as well as the actions of our leaders in addressing this recession and bursting credit bubble.

Trillions of printed and borrowed dollars are being thrown at an overly-indebted economy in a ridiculous effort to boost economic production back to levels that were only attained in the first place by an ever-expanding and unsustainable amount of debt/credit. You don't fix a debt problem by borrowing, and you don't fix a problem of nonperforming assets by printing money and bailing everyone out. Excesses have been built up over the past 10+ years that need to be unwound. Balance sheets need to be repaired (people need to save more and pay down debt), asset prices need to fall back to economically-justifiable levels, and industrial and retail capacity needs to readjust downward to a more sustainable level of demand (companies need to fail). Nothing that the government or the Federal Reserve is doing is encouraging this. In fact, they're actively trying to forestall this natural economic process.

Our leaders are taking a terrible gamble. They are borrowing and printing money on an unprecedented scale in an effort to stimulate lending in an overleveraged economy. The odds of their plans working smoothly are terribly small, as we've already seen. They have no play book for our present scenario because we're in uncharted territory. Political motivation and a belief in a failed economic theory has resulted in our leaders once again focusing on a quick fix at any cost rather than the long-term health of our economy.

The bottom line is that we are unlikely to see a strong and sustained improvement in the economy any time soon. In fact, we should be much more concerned with the eventual likely repercussions of the current "solutions" -- higher inflation, rising interest rates, a renewed and prolonged economic slump, and/or a sharp decline in the value of our dollar. My concern that this may be the path we're on has increased steadily with each passing month and with each announcement of a new or larger stimulus package.

Although my concerns may not play out for some time (it could take years), our portfolios are positioned in a manner to provide some protection and hopefully benefit when they do come to pass.

- We own gold and gold shares. If the dollar runs into serious trouble, I would expect people to flock to gold as a safe haven and store of value.

- We also have some foreign currency exposure, specifically the Canadian and Australian dollars. These currencies should benefit from any inflationary pressure on commodities since these are resource-based countries.

- Where appropriate, we own and will own inflation-protected government bonds (TIPS). The price of these bonds rises and falls with consumer inflation, so the interest payments will rise and fall accordingly. My concern here is that these prices are based on the government's calculation of the Consumer Price Index (CPI). The government has an incentive to manipulate this index downward since many of its payments are based upon it (think Social Security). Also, there is a very good chance that the inflation we see may be more directed at commodities. Only a portion of this may flow through to CPI.

- Outside of TIPS, we have largely avoided the fixed income market. If my concerns are correct, then higher future interest rates will decimate much of the fixed income investment world. Furthermore, yields don't currently offer adequate protection from future default, generally speaking. Although you've probably read or heard "experts" claiming that bonds are attractive due to record yield spreads (the yield/interest rate that a bond is paying relative to "risk-free" Treasury securities), it's important to keep in mind that Treasury yields are near record (or at least long-term) lows due to deflation concerns and outright manipulation on the part of the Fed. The risk of rates moving higher over the next 5-10 years is much greater than yields falling. Remember, prices move inversely to yields, so if interest rates start rising, the price of your bonds will fall.

- We are mostly keeping the fixed income portion of portfolios in either TIPS or money market funds. Although money market funds have terribly small yields right now (you can thank the Fed for that), it is much more important to keep this money safe and protected than to get burned by chasing yield.

- We will not be greedy with the more tactical portion of our portfolio. While there are a number of securities that I expect us to own for some years, we will be relatively quick to take gains in the shorter-term portion of each portfolio.

- We have exposure to various commodities and commodity-related stocks. I do expect commodities to be a prime beneficiary should inflation really heat up. The current downturn is having a meaningful impact on reducing the supply of many commodities, and I expect prices to ultimately move much higher than the consensus is anticipating.

Fortunately, this strategy should benefit us even if my most serious concerns don't come to pass. The primary scenario in which this strategy would not perform well is that of the Great Depression II. However, our leaders have already committed to over $12 trillion in stimulus (including guarantees), and we have a Federal Reserve Chairman who believes that the Great Depression could have been prevented by quicker and more aggressive monetary easing (lowering rates and printing money). I believe the odds of a deflationary spiral are rather low.

As far as what to expect with performance, I would certainly expect us to underperform in a strong rising market. Since we are reducing exposure as this rally continues, the longer it runs the more we will underperform in the near-term. Our increasingly more conservative position, however, should benefit us if the market rolls back over and declines anew. In the case of a flattish or range-bound market, I would expect us to do well over time due to superior security selection.

I'll conclude this quarterly review with some commentary from Aspera's Chief Investment Strategist. Since joining Aspera, she has an unblemished record of accurate market predictions, and I discuss all major trades with her. A video of her current market view can be seen at the following link: Link to video

Best,

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President
Aspera Financial, LLC

4/5/09