ASPERA REVIEW
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1Q10 Portfolio Review: Biding Our Time

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"The more you observe politics, the more you've got to admit that each party is worse than the other."

Will Rogers

It seems that I've actually been underestimating the precariousness of our situation. As many of you know, I'm an aspiring future mall-walker. Our colder than normal winter forced me inside to the gym and the treadmill for a few weeks this winter. I'm not a TV watcher, but the treadmills in the cardio room all face six large televisions on the wall, so they're hard to ignore. What I saw on those televisions over those few weeks completely annihilated what little of my innocence remained.

For starters, I caught glimpses of a show called "Cheaters." Apparently an aggrieved spouse or partner has a team of investigators follow their soon-to-be-ex-loved one around to catch them in the act of cheating. The show culminates in a shouting match and Taiwanese-parliament-like brawl. If I really want to see people cheating, lying, being humiliated, and acting amoral, I can just watch CNBC.

Next, as much as I enjoy ESPN, the media frenzy surrounding Tiger Wood's "predicament" was a bit tiresome. The poor guy accidentally falls into 9-10 attractive naked women, and the media goes crazy. The real story is how someone who is so graceful on the golf course can be so uncoordinated away from the course. Still, if I want to watch untrustworthy people trying to screw one another, I can just watch CNBC.

I was also introduced to "Jersey Shore." Does New Jersey really need another knock against it? I can't believe that our tax dollars will be going toward the future welfare and public defense of these "stars." If there's any chance that we can sell the entire state of New Jersey to Sicily or the producers of "Celebrity Rehab," we should act quickly. I'd even be willing to swap the state for a pile of Greek government bonds. If I want to watch a bunch of mindless, self-absorbed, reality stars prattle on for hours, I can just watch CNBC.

Finally, one of the televisions was always tuned to C-SPAN. I was shocked at how intelligent, honest, and reputable each Congressperson seemed. It took a week for me to realize that the volume was muted.

So, a few weeks of running inside on the treadmill left me in marginally better physical condition but somewhat mentally impaired. I've tried to be particularly careful when placing any trades during this time period. Fortunately, the return of spring-like weather is serving to repair the damage. Still, it's difficult to be hopeful for our future when more Americans can identify Snooki than a Treasury bond.

If At First You Don't Succeed – Reflate, Reflate Again

I'm not sure whether television programming, our economy, the government, or the markets is more dysfunctional. The short-sightedness of our leadership and of market participants is breathtaking. Your average investor, Congressman, and voting Federal Reserve member all seem to have the attention span of a moth (no offense to moths). Perhaps this short-sightedness is what allows the markets to churn ever higher despite unprecedented economic risks, unattractive valuation, an expanding global debt bubble, increasing trade tensions, massive state budget shortfalls, eye-popping unfunded public pensions, etc.

Rising markets can be dangerous in that they breed complacency. Investors often assume that a rising market equates with a low-risk environment. The longer the market rises, the more safe it is deemed to be. Conversely, a falling market is often thought to be very risky. Of course, a market is most dangerous at its high after it has been rising for some time, and it's most compelling after it has already fallen dramatically. Let's be careful in the current environment to not make the mistake of confusing this rising market with a safe market.

Valuation and fundamentals always matter eventually, though they're of little concern today. For the time being, this market is being driven higher on low volume with trading concentrated in a ridiculously small number of stocks. Much of the activity occurs after hours and is dominated by a handful of government-supported zombie banks. We may eventually find that this market is being shoved higher simply by these banks trading the same few securities back and forth between each other at ever higher prices. This is a dangerous game. When the tide turns, we could see a fairly quick rush to the exit without much real buying to support prices.

It's clear that another attempted reflation is underway. Investors have forgotten the lessons of 2008 and have flocked back to risky securities in an effort to boost their yield/return. With risk-free securities still yielding close to 0%, it's no wonder this is occurring. Unfortunately, many people (particularly retirees) who have little ability to withstand another hit to their investment portfolios feel compelled to take on more risk in an effort to generate the income they need to put food on their tables. They likely have no idea how much risk they're actually incurring. There is a very good chance that this will end badly for them. If you don't want your parents moving in with you, this would be a good time to take a peek at their investments.

All that currently matters is the belief that the Federal Reserve will continue to use all means possible to prevent the next (inevitable) downturn which their massive stimulus is actually ensuring. Although the Fed claims to be winding down its stimulus measures, market participants have little doubt that the Fed will jump right back in at the next hint of trouble. This warranted belief helps to underpin security prices. Although there is no room left to lower short-term interest rates, Bernanke has shown a willingness to print dollars in order to directly buy risky securities from the private sector. Again, this certainly can support asset prices in the short-term.

Unfortunately, this can not work indefinitely. The higher asset prices climb absent a sustainable economic underpinning, the harder they'll eventually fall. In addition, printing money out of thin air is the very definition of inflation. Just as the issue of blowback exists in foreign policy, it exists in economic policy. I suspect that we're rapidly approaching the point at which the market will be hard-pressed to ignore such intentional and aggressive inflationary measures. Once that point arrives, the 30-year bond bull market will be officially over. Interest rates will climb to reflect rising inflationary expectations (as well as deteriorating creditworthiness). Rising rates will pressure company balance sheets, homeowners, and equity valuation. We've recently seen a fairly significant move in long-term Treasury yields, but it remains to be seen if this is a temporary move or the beginning of a trend.

We may not be playing the game, but we are protecting ourselves from the most likely outcome of this game. TIPs, our short of long-term Treasuries, and our commodity and energy positions should all provide some protection. Our precious metal positions, in particular, should continue to provide an offset to this reflation and continued monetary mismanagement.

So, we'll continue to let the powers-that-be have their fun with their little game. The current Ponzi dynamics may continue to pump up risky assets for some time, but buying overvalued assets in the hope

of selling them to a greedier idiot is a fool's game. Let's not forget the last 10 years of the U.S. stock market or the last 20 years for Japan. We will most likely look back again and find that this current rally was simply the latest head fake. The ingredients for a new secular bull market remain notably absent.

You Think You're Got Problems?!

The similarities between the present market and that of the Great Depression are uncanny. The market fell dramatically in 1929 and then staged a powerful rally. During that rally, the experts of the time were convinced that the worst was behind them and that it was a wonderful and safe time to again buy stocks. The market eventually went on to make new lows. Today's circumstances are certainly not exactly like those of the Great Depression, but many parts rhyme. More importantly, human nature hasn't evolved too terribly much in the past century. Our current rally smells eerily similar to that of 1929-1930.

Now, brace yourself because I'm going to say it again. Despite the rhetoric from Washington, Wall Street, and the main stream media, the crisis is not over. We've come through Act 1 of the drama. I believe that we're still in the middle of a secular bear market. There are many headwinds that we face. This alone doesn't lead us to a conservative positioning, but these headwinds coupled with expensive valuation certainly does. Some catalyst will eventually stop this rally in risky assets, and it may well be something that isn't even on the radar currently. Still, here are some of the headwinds we're watching:

- The U.S. economy remains dependent on government spending and a weak dollar.
- Every country wants to spur growth by increasing exports to other countries. Who exactly is supposed to be the buyer? It should be the surplus countries like Germany and China, but they've shown no inclination to "take one for the team." One of the few tools many countries have left is the ability to devalue their currency, and we expect them to use it.
- Additional private debt can no longer be counted on to boost economic growth. The paying down and writing off of debt will prove a drag on growth for many years.
- Sovereign credit quality is rapidly worsening throughout the developed world. Even leading emerging countries such as China and India have a greater debt burden than is generally recognized. Sovereign credit risk is rising and is likely to lead to higher risk premiums and yields. Ireland, Dubai, and Greece were shots across the bow.
- Corporations have done a fantastic job of boosting earnings this past year, but it has all come from cost cutting. Sales will have to pick up to generate meaningful earnings growth.
- Housing bubbles in China, Canada, and Australia will inevitably burst.
- U.S. states are still running massive cumulative deficits and need to cut spending and/or raise taxes.
- Public pension plans are ridiculously underfunded. Many are assuming 8-9% investment returns. If they used more realistic assumptions, their liabilities would explode. Wisconsin will now be using leverage in an attempt to boost returns. I'm sure that will work well!

I don't enjoy being bearish. I was thrilled to turn bullish early last year for the first time in years. Unfortunately, that bullishness lasted for all of a few months. It seems I've spent much of the last decade warning about overvaluation, structural imbalances, poor policy prescriptions, and the danger, reliance, and unsustainability of massive debt growth. It's frustrating to have to again reprise this all too familiar role.

Performance

U.S. equity markets posted a solid return in the 5% range for the quarter. International markets returned a more modest 1.5% while emerging markets split the difference. Interestingly, China was the laggard this quarter with a loss of 5%. This bears watching as any slowing in China could foretell problems elsewhere. Bonds posted a modest gain of about 1% generally. The commodity index lost 5% despite a 4% increase in oil. The dollar posted a modest gain, helped by a nearly 6% decline in the value of the Euro as southern European debt issues took center stage last quarter. Gold actually held in there and posted a slight

increase despite the stronger dollar (they typically move in opposite directions) and despite this being a seasonally weak time of year for the metal. At some point, I expect to see gold break out to new highs.

Index/Market	1Q10
S&P 500	4.87%
DJIA	4.11%
Nasdaq	5.68%
Vanguard Total Stock Market (VTI)	5.71%
Vanguard International Stock Index (VGTSX)	1.53%
China - Shanghai A Share Index	-5.16%
Wisdom Tree India Earnings (EPI)	5.71%
Emerging Markets (VWO)	2.80%
iShares Aggregate Bond (AGG)	0.98%
Dow Jones Commodity Index (DJP)	-5.68%
DPDR Gold Trust (GLD)	1.53%
Oil	4.15%
U.S. Dollar (UUP)	3.12%

Our performance continues to closely track…well, nothing really. This shouldn't be too surprising given our contrarian philosophy, investment latitude, and our lack of concern with trying to mimic any benchmark over the short-term. In general, we remain in somewhat of a holding pattern. On a net basis, we remain conservatively positioned and are unlikely to see dramatic moves in performance. This was borne out in the first quarter in which we saw little change in our portfolios. In general, our more aggressive portfolios modestly underperformed our more conservative portfolios.

Our worst performers continued to be our hedge positions which are held to manage overall portfolio risk. Since these tend to move counter to the general market, their weakness in a rising market is expected. Our energy names also moved against us in the quarter. Also of note, our core position in DBA (which tracks 4 agricultural commodities) was down 8% in the quarter.

Our best performers included EPD, APL, GMO, a couple of our junior gold miners (GSS and EGI), as well as our short of PALM. EPD is a pipeline limited partnership. This space continues to perform well as investors reach for yield. APL is also an energy limited partnership, but it doesn't currently pay a distribution as management is busily attempting to improve the company's balance sheet. This stock is up 300% since its low of last year.

Our precious metals position is our single largest core bet, and its performance was mixed overall. Despite the nice gainers mentioned above, we had a couple of other names (MFN and AUY) which fell over 10% in the quarter. More importantly, our larger metals positions underperformed the broader market, albeit modestly. GDX fell 4%, GDXJ was flat, GLD was up 1.5% and SLV gained 3.6%. This was actually a fairly muted quarter for these typically volatile names. I am very pleased with these positions overall given the typical seasonal weakness experienced this time of year.

Portfolio Positioning

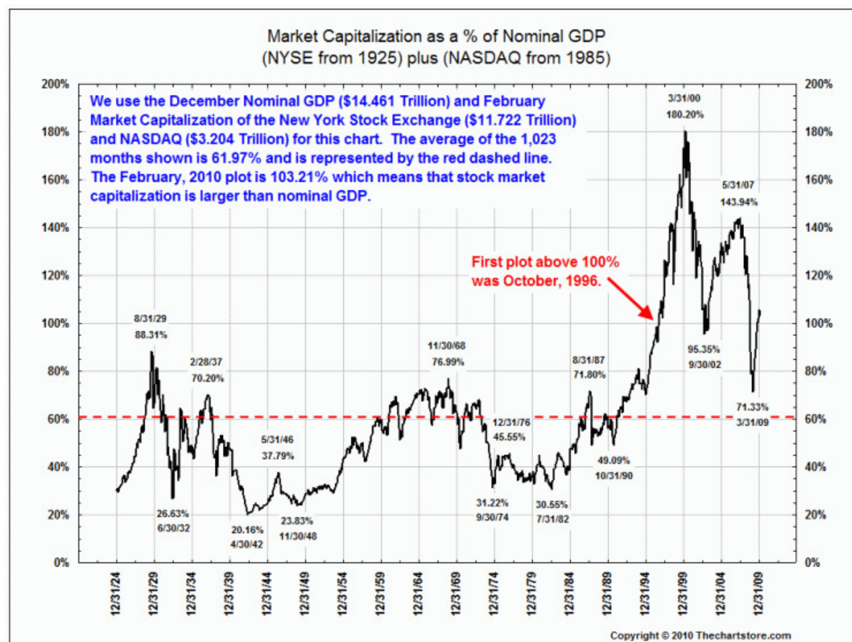
Our positioning hasn't changed much in recent months. We continue to be fairly conservatively positioned with modest net exposure to risky assets. We remain overweight the precious metals and energy sector and underweight the financial and consumer space. We continue to tread carefully when it comes to income-oriented securities. We remain biased toward cash, inflation-protected bonds, limited partnerships, and shorter-term and high-quality corporate bonds.

Our focus remains much more on wealth preservation than on growth. We are NOT positioned for big returns at this time, so we will continue to underperform risky assets in the near-term should they continue rising. The best environment for us would be one with a modestly declining equity market and strong

precious metals performance. Since the precious metals positions have been largely moving with the equity market, any decline in equities will probably mean a decline in our metals positions in the short-term. Eventually, we expect to see a divergence between the metals and the general equity market. In the meantime, we hope to hit some singles and doubles while limiting our downside risk. At some point when more attractively priced opportunities are available, we'll take more risk and focus again on growth.

"I just went all in . My financial adviser who got me out in March of 2009 says it's safe to get back in now"

The U.S. equity market is expensive based on a variety of time-tested valuation metrics. To be clear, we are well off of record high bubble valuation levels experienced this past decade, but we also no longer have the tremendous tailwinds of falling interest rates and expanding debt to boost asset prices. Current valuation is in the top 10-20% historically. The record shows (and common sense dictates) that buying richly valued assets leads to unsatisfactory long-term returns.



We have a few choices in such a world.

1. We can ignore valuation and fundamentals and join the party with fingers crossed that "it's different this time."
2. We can look beyond the U.S.
3. We can sit on our hands.
4. We can focus on those sectors and securities which still offer value.

Our game plan is clearly not #1. Valuation is critical. You make your money when you buy. If we don't focus on what value we receive for the price paid, we simply become gamblers and fools.

We are pursuing #2. Fortunately, we are not limited to the U.S. equity market. Unfortunately, all risky markets have risen together this past year. There has been no benefit from diversification. This is not normal, but it has been our reality for the past couple of years. As a result, it is difficult to find many attractive opportunities even outside of the U.S. China, Canada, and Australia all have real estate bubbles which will eventually pop. Certain equity markets, such as China, are very richly valued and leave little margin of safety. The developed world has a massive debt problem which is quickly coming due. We currently have no direct exposure to foreign equity markets. Longer-term, some of the emerging markets look attractive, but those better growth prospects are already largely reflected in share prices. We'll be aggressive buyers after these markets stumble and investors flee.

We are sitting on our hands in the sense of not taking much net risk in our portfolios at the time, but we're not simply sitting in cash. The key to long-term investment performance and survival is to take risk when it pays to take risk. It really is that simple. Remaining conservatively positioned when asset prices are overvalued is never a bad decision. Eventually, the strong correlation across global risk assets will break down, giving rise to more and better opportunities.

Although the general equity markets are not attractive, we continue to focus on sectors and securities which still offer value, and there still are some out there. Our performance is likely to be driven by our precious metal exposure for some time. Energy will also be a driver. We remain biased toward commodities (hard assets) versus financial assets, but we've been waiting for a pullback to boost this exposure again. China has had a voracious appetite for commodities in recent years, but evidence of stockpiling and excess production capacity are bound to lead to a slowing at some point. Timing such a slowdown, however, is not at all simple. For the most part, we're remaining on the sidelines when it comes to commodities and China. We expect another terrific buying opportunity at some point.

Trading Activity - Closed or Reduced Positions

Trading activity was fairly muted in the quarter. I discussed CHK and RWM in the last ("Mamma Mia") Bulletin. The following positions were closed out or reduced during the quarter.

Natural Gas

In retrospect, I should have sold our entire position in UNG back in December rather than just half if for no other reason than I wouldn't have to revisit it a second time in a Quarterly Review. UNG has always been a little more complicated than our other energy positions because its performance is based on the direction of natural gas prices, the shape of the natural gas futures curve, and the shifting of that curve. When we sold the first half, the fundamentals of natural gas had actually improved dramatically with supply having fallen from a huge surplus to more normal seasonal levels. The price of natural gas had also doubled. Because of the strategy employed by UNG, however, it did not participate. I felt at that time that there was still a good chance that UNG would benefit from an improving supply situation, and we did see a fairly quick move in the security from the $8 range to $10. However, this wasn't sustained.

By early March it was becoming clear to me that the market was looking beyond the improved supply picture. A rebounding rig count was likely to lead to a pick-up in supply later this year at a time when the economy was likely to be slowing again. If there was going to be an improvement in the shape of the

futures curve and the performance of UNG, it should have happened by early March. Whenever I reach the conclusion that I wouldn't be willing to put new money in an existing name, it's time to move on.

Our other energy names have performed well, but that's small comfort for what was clearly a disappointing investment, particularly relative to my initial expectations and the actual improvement in natural gas fundamentals that occurred. This does, however, highlight the reason why we spread sector bets across multiple securities rather than bet the farm on any one.

Novatel

When I wrote about our Novatel position (NVTL), I cautioned about the cockroach theory. I viewed the company's fourth quarter earnings report as a make or break point for the position. Despite rave reviews, the company just wasn't able to gain traction with its product over the holiday season. It's likely that the carriers which sell the product had a difficult time explaining it to consumers. With competition in this space heating up this year and with consumers watching their wallets, the operating environment for NVTL won't be getting any easier. Given all of this and my desire to further reduce risk exposure in our portfolios, selling NVTL was an easy decision.

Cotton

On a brighter note, we sold our position in BAL at a nice profit. This security tracks the price of cotton. This was particularly gratifying in that the price of cotton was rising and reached our sell target at a time when most other agricultural commodities were being hit hard. We may be adding to some of these other names in the near future if the sell-off continues.

PALM

Our short in PALM was covered in the quarter. This was a strong performer as it was shorted at $14 and bought back at $8.50 for a nice gain. It's always nice to have a short position work well in a rising market. Our short of PALM was based on our belief that the company would not be able to compete with Apple and Google. We were a little too quick to take profits, but it's always a good policy to leave something on the table for the next guy.

SRGL

We also sold our position in Source Gold (SRGL). This is a highly speculative junior mining company exploring for gold in Ontario, and the position was meant as a short-term tactical buy. The position was owned for 2 months and closed out for a 30% gain.

Trading Activity - New or Increased Positions

AEM

We boosted our exposure to Agnico-Eagle Mines early in the quarter. This (primarily gold) mining firm was beaten up late last year when they reported some delays in the start-up of production at some of their new mines. In fairness, the company was being very aggressive in trying to oversee a rapid expansion of activity across the globe at various mines simultaneously. The market punished the stock for the delays, but this provided us a nice entry. The company has since reaffirmed that it is back on track and the production issues have been addressed. Agnico will be posting impressive production growth over the next couple of years. I expect to see this stock benefit from rising gold prices, a leveraging of fixed costs, and a narrowing credibility discount as they prove to the market that they've licked their start-up issues.

SLV

We increased our exposure to silver in a number of accounts. SLV had pulled back to the $15-16 range, a very attractive level. We have room to add here should prices weaken again. Ultimately, I suspect the price of silver will climb much higher than most think possible.

FCX

We added a short position in FCX (Freeport McMoran Copper & Gold). Although the company does have gold and silver assets which we like, FCX is the world's largest publicly traded copper company. With China endeavoring to combat inflation and curb its property boom, this is a bet on a slowdown in copper

purchases from China. The biggest risk here is timing risk, as bubbles can always last longer than is rational.

TESO
We added Tesco (TESO) to the portfolio toward the end of the quarter. TESO is a small energy service company which manufactures, sells, and leases top drive drilling systems (a critical component of a drilling rig). They also have a proprietary system which allows a well to be cased as it's being drilled. I would be surprised if Tesco is not eventually bought out by one of the larger energy service players.

Strategy and Outlook

> People are always asking me where is the outlook good, but that's the wrong question. The right question is: Where is the outlook the most miserable? I call this the principle of maximum pessimism. Let me explain how it works. In almost every activity of normal life people try to go where the outlook is the best. You look for a job in an industry with a good future, or build a factory where prospects are best. But my contention is if you are selecting publicly traded investments, you have to do the opposite. You're trying to buy a share at the lowest possible price in relation to what that corporation is worth. And there is only one reason a share goes to a bargain price – because other people are selling. There is no other reason. To get a bargain price, you've got to look for where the public is most frightened and pessimistic.
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> Sir John Templeton

We certainly don't need a perfect global economic outlook to be bullish. My brief bullish stint in early 2009 was hardly accompanied by a robust economy or outlook. What we need is for asset prices to at least realistically discount the headwinds that we face, be they few or many. Today, the market seems to see a strong and sustainable recovery buoyed by perpetually low interest rates. I think the market is suffering from cataracts, lazy eye, and a severe astigmatism. Even if I'm wrong and the economy is in the early stages of a solid and sustainable rebound, this is already priced into the equity markets.

What I do see is the increasing likelihood of another train wreck. 2008 and 2009 should have been the years in which we finally addressed our debt overhang and our structural imbalances, but they proved instead to be the years in which we reinforced and expanded those imbalances. The private sector debt bubble is being supplanted by a government debt bubble, and the Fed is now left with the blunt tools of money-printing and dollar devaluation to fight its next battle. The next downturn is almost certain to be even greater in magnitude unless voluntary measures are taken to address them -- and soon. Given the current mood in Washington and the roughshod way in which healthcare legislation was just passed, it's difficult to imagine a productive period of bipartisanship any time soon. The lunatics are still running the asylum.

The risk of a double-dip recession occurring later this year is much greater than the experts perceive, particularly if another substantial stimulus package isn't forthcoming. The "strong" 5.6% GDP growth reported for the fourth quarter of last year owes much to government spending, a weak dollar, and inventory restocking. This is not the foundation of a sustainable recovery. Until balance sheets are improved, we simply can't expect the consumer to drive the economy. As long as the consumer is retrenching and excess capacity exists, it will be difficult to generate sustained new investment. I suspect we'll experience a Japan-like period of little real growth for some time to come. Short-term factors will conspire at times to temporarily boost GDP (like last quarter), but this will eventually be unwound. These temporary "improvements" are to be sold, and the relapses may provide buying opportunities. Fortunately, our contrarian tendencies lend themselves to such action.

There should be no surprises when it comes to performance, so I'll try to be clear. I have no intention of drinking the Kool-aid. Patience remains the order of the day as does wealth preservation. Don't be fooled into thinking that this rising market is without risk. Ignore the market, and don't worry about your portfolio. We tend to be ziggers when others are zaggers. As I've accurately been warning for a few quarters, we

will lag a strongly rising market. My concern is not 2010 performance. My concern is our performance over this decade.

The value of risk management is seldom appreciated at times like these, but it's the most important thing that I do. It tends to be ignored and even disparaged when markets are rising, but this is often when it's most important. Portfolio return must always be considered in the context of how much risk was taken to generate it. The dramatic reduction in market volatility over the past year is lulling many into a false sense of security and complacency, but it's always most calm before the storm. The value of our focus on risk management will eventually be once again borne out.

I strongly recommend a review of my Bulletin from last August entitled "The Idiot/Genius Cycle." For those following along, we remain in Phase 5 of the Idiot/Genius cycle in which "Ken is an Idiot." Just in case you don't review the entire piece, here are two important paragraphs:

> Clearly, you need some self-confidence to survive this cycle because you're an idiot for 2 of the 6 phases. In actuality, these idiot phases are critically important in terms of my investment strategy and discipline. They are also the reason I spend so much time harping about the need to focus on the long-term and why I caution that we will (and must) underperform at times in the short-term. It must be understood that I will appear to be an idiot for a good portion of the time that I'm responsible for my clients' portfolios. It's by design, it's inevitable, and it's a key driver of long-term performance.
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> There is no definite time frame for each phase of the cycle. Phases can occur very rapidly over a span of days or weeks, or (more likely) they can stretch over months and years. Understandably, I prefer the idiot phases to be brief, but I have little control over that. Fortunately, I'm often most comfortable in this phase as it offers the best opportunity to get positioned for the ensuing more enjoyable phases.

I'm fortunate in that I find it easy to ignore the madness of crowds. For now, the crowd again loves risk. House flipping and day trading are apparently popular again. Well, we'll step back and watch the public devour their bread and enjoy their circuses. Some day the bulls will look back and lie to their clients and children about how they knew this was just a bear-market rally. We've seen this same play too many times before. In the meantime, we'll quietly go about our business of looking for value and patiently waiting to add risk when we're adequately paid to do so. The dawning of a Genius phase draws nearer with each passing day.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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