ASPERA REVIEW

Intelligent, Independent Investment Management

Second Quarter 2009 – Mid-Year Update

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Like everyone else, I would love for the economy to have a strong and sustained healthy recovery, and I'd love for the recent rally in global stock markets (and most everything else) to be the beginning of the next great bull market. If I could ignore security valuation, only read press release headlines, and if I could suppress my gag reflex long enough to watch CNBC, I'd probably be very bullish right now. I'd also do far less mumbling under my breath, and I'd be far less prone to developing facial tics.

When looking at the economy, the question isn't whether the glass is half empty or half full. The question is: Why did the government bail out the lousy, uncompetitive, bankrupt glass manufacturer in the first place? And why is the glass stuffed with Treasury bonds and sitting on Tim Geithner's trophy shelf alongside his collection of embroidered Wall Street-logo glass cozies? And just who is Tim going to sell this chipped lip-imprinted glass to when he needs to wind down his stimulus? Ok, the glass is half empty.

The biggest surprise about the economy and market so far this year is that it has been playing out largely as I expected. Let's do a quick review. The big market sell-off and Son of Depression panic back in the first quarter were overdone and offered a great entry point. Evidence of a slowing in the rate of economic deterioration then led to a strong rally across virtually all asset classes as investors realized that the world would not be ending just yet. Further hints of recovery, a return of optimism, and cash coming in from the sidelines gave the rally some legs. This strong market and economic optimism has now resulted in a consensus view that the worst is behind us and that we should experience a more normal post-recessionary recovery.

Earlier this year, references to the Great Depression were everywhere. I believe it was one of the most searched Google terms, right up there with "debt consolidation," "foreclosure," "hair removal," and "Jon and Kate." Today, the most overused term is "green shoots" which is supposed to convey an image of a budding recovery. Let's not forget that every weed also begins as a green shoot. Personally, I do not see much evidence of green shoots. Much of the supposed good news that the pundits and press have been salivating over has been underwhelming at best and disingenuously misinterpreted and twisted at worst. We may all want to see a strong recovery and a new bull market, but hoping doesn't make it so.

A Balance Sheet Recession

For present purposes, I'll avoid running through the details of the numerous economic indicators I follow and how poor a job the press and punditry have done in interpreting the data. I'm doing this for a couple of reasons. First, I like you. Second, it's easy to get lost in the minutiae of weekly and

monthly indicators. The economists will continue to scour each economic release for signs that the recession is over. We'veseen plenty of early and wrong calls so far, and we'll hear plenty more. For us, it is more important and productive to stay focused on the 20,000 foot view. As always, we can boil everything down to fundamentals and valuation.

As for the fundamentals, the single most important point to understand is that this is a balance sheet recession. This is not your typical inventory-led recession. Those who are forecasting our future course based on an analysis of post-war recessions are flying blind. Our situation is much more similar to the Great Depression and the 20-year Japanese L-Shaped recession (20 years and counting). Our path from here doesn't necessarily have to follow either of those examples, but it's critical to understand that there is nothing "normal" about our current predicament.

In your run-of-the-mill inventory-led recession, an over-expansion of business capacity leads firms to rein in their inventory. Orders are reduced, business in the pipeline slows, firms lay people off, consumers pull back, and economic activity slips. To "help" the economy, the Fed typically lowers interest rates to encourage consumer borrowing and business investment. Congress often joins the party by passing a fiscal stimulus bill to further goose the economy. Eventually, demand and supply come back into balance, and the economy recovers.

Our balance sheet recession is a very different beast. It was caused by too much debt in the economy. This debt was encouraged by the Fed keeping rates too low for too long as well as lax underwriting standards, poor credit analysis, increased risk taking, consumer ignorance (no excuse), etc. Leading up to the peak of the cycle, this debt was used for speculative purposes instead of productive purposes. Debt which is used for productive investment and which generates a greater return than the cost of that debt can be very useful and productive. Debt which is used for purely speculative or consumptive purposes is unproductive and potentially destructive.

Our problem is that we have been financing our economic growth with debt over the past decade. With each passing year, it took more and more debt to finance each dollar of economic growth. Just prior to the housing collapse, mortgage equity withdrawals were almost singlehandedly responsible for all of our economic growth as homeowners treated their homes as ATMs to finance a lifestyle they couldn't really afford. Those days are gone. We are saddled with a huge debt which is "supported" by falling asset prices. Cash flow and asset prices are falling, but the debt remains.

It may be helpful to consider our predicament in terms of an actual balance sheet. Assets (like your home and investment portfolio) are on the left-hand side of the balance sheet, and liabilities (mortgage) and equity (net worth) are both on the right side. Your net worth (or equity) is equal to your assets minus your liabilities. The two sides of the balance sheet must equal, unless you're Bernie Madoff. With the decline in home prices and investment portfolios, the asset side of the balance sheet has taken a huge hit. Unfortunately, the liabilities (mortgage/loans) that supported those assets haven't fallen. The net effect of this is a decline in net worth. Most people are much less wealthy than they thought they were just one year ago.

To repair a balance sheet problem, there are only a few options. Assets have to increase or liabilities have to fall. We're unlikely to see home prices and equity markets make up their lost ground any time soon, so asset reflation alone isn't likely to do the trick. The other way to increase assets is through savings, and we've started to see the savings rate head back up (from less than zero) in recent months. This is the one mechanism on the asset side that is somewhat in our control.

On the liability side, our options are also limited. Unless your lenders are willing to reduce the amount of your loans, the only option is bankruptcy/foreclosure or to pay down your loan. Once we recognize that this is a balance sheet recession, we can see that the remedy must come from either an asset reflation (possible but not likely), increased savings, debt restructuring, debt reduction, or insolvency/foreclosure. Think about the ramifications of this for spending, hiring, and GDP.

Sound and sustainable economic growth is driven by savings and investment (business investment as opposed to stock market investment). The savings rate is slowly starting to creep back up as decimated

consumers look to repair their balance sheets the old-fashioned way. This is healthy and necessary. This increased savings, however, is not being lent for business investment. One reason is the reluctance of banks to lend given their own balance sheet problems. Even more important is the fact that there is little need for businesses to borrow for investment purposes with so much excess production capacity in the system. Most of the loan demand from businesses is simply to roll over existing maturing debt into new debt.

Government Intervention

I'll save a detailed discussion of the $13+ trillion in government stimulus for a later date, but I'd like to make a few important points. Whatever progress the private sector is making in reducing debt is being offset by a ballooning of debt at the government level. Borrowing money to sustain an unsustainable lifestyle is precisely what got consumers in trouble, and it's precisely what the government is now doing itself. You do not solve a debt problem through borrowing. You do not solve a debt problem (or generate growth) by expropriating funds from certain groups to give to other special interests. You do not create wealth by taking ever-larger sums of money from one group and giving it to another. We have a name for that. It's called a Ponzi scheme. You do not solve a debt problem by saddling our children with a debt load that they did not incur. You do not solve a debt problem by stifling the natural corrective mechanisms inherent in the free market. You do not solve a debt problem by rewarding failure (think the largest banks) and punishing success (think prudent community banks).

I have a deep interest in the policies that come from Washington because they have a bearing on the investment climate and my expectations for future returns. I was critical of the policies enacted under Bush, and I'm critical of the policies being enacted under Obama. Neither party has been "right" when it comes to economic policy for a long time.

Regardless of Democrat or Republican, the steps that the government has taken do not instill confidence in this investor. There will be unpredictable blowback from their actions that we'll be dealing with for many years. The ballooning of the debt and the balance sheet of the Federal Reserve are unlikely to be unwound smoothly. We could see serious repercussions when it comes to inflation and the value of the dollar. We risk rising interest rates which would increase the cost of our debt, reduce the creditworthiness of the United States, and forestall any significant improvement in economic growth. We also risk a prolonged Japanese-style economic stagnation. Much more can go wrong from this point on than is generally recognized.

It's also critical to understand the goal of the federal stimulus. The government is attempting to fill the gap between where economic output was prior to the downturn and where it is today. This is called the output gap. The problem *should* be obvious. Our peak economic output was only achieved by excessive borrowing. It was never "real." Trying to sustain that level of output is absurd, and it's adding nearly $2 trillion to our debt burden this year alone. The government refuses to let the market correct to a healthy level from which we can responsibly grow again. Government policies are attempting to pull demand forward from future years to plug the current output gap. This may appear to work in the short-term, but there is a tremendous cost associated with it. Let's not forget that this accelerated demand won't be there in the next few years.

One thing that I can say with certainty is that the government policies, budgets, and bailouts which have already been passed and those that are in the works (cap-and-trade and healthcare) are decreasing the attractiveness of U.S. financial assets and increasing their risk. As an investor, I "demand" higher expected future returns from assets for incurring this additional risk. If there are enough like-minded investors, asset prices will need to fall in order to provide us with the higher future returns we need for incurring this higher degree of risk.

Punchline: No Strong Sustained Recovery

The point of the previous discussion is to illustrate that we're in a much different economic and investment environment than most people appreciate. Balance sheets need to be repaired. This is imperative, but this takes time. Although government money may appear to help in the short-term, their actions will only make matters worse in time. The fact that this recession is occurring on a global level only further exacerbates its severity.

With our GDP (economic output) driven nearly 70% by consumption, it's difficult to imagine *sustained strong* economic growth over the next few years. Consumers need to increase savings and spend less in order to repair their balance sheets. Combine this with continued job losses and stagnating wages, and it should be clear that our days of strong consumption may be gone for some time.

With consumption falling, it's difficult to imagine a strong and sustained rebound in corporate investment any time soon. In fact, capacity utilization is currently at its lowest level on record (since 1964). Once demand eventually rebounds, we'll see companies bring back mothballed capacity before any significant capacity is added. This is yet another GDP headwind.

That leaves government spending and net exports. I fully expect government spending to remain elevated for some time. I would be shocked if Congress does not approve another stimulus bill in the next 12-18 months. This will add to GDP, but it's simply taking money from one group and giving it to another. This is not real growth. It's anti-Robin Hood economics. Rob from our children and give to the investment banks. Net exports may boost GDP if the dollar continues to weaken with the caveat that other more export-dependent countries may pursue a course of currency devaluation to protect their own economies.

Let's not forget the financial system. It's still fragile. Capital is scarce, the economy is credit-constrained, and the banks are more concerned with survival than with growing their loan portfolios. Much of the lending that is occurring is simply replacing maturing and existing debt rather than financing new growth. This is hardly a recipe for strong sustained economic growth.

I suspect we may be in for a period of increased economic volatility. Signs of improvement will give way to evidence of slowing much more frequently than we've been used to. This bi-polar economy will probably result in continued large swings in the market. This is not a "buy-and-hold" environment.

Valuation and The Market

We do not need robust fundamentals to have attractive investment opportunities. The economy was a mess in Feb/Mar, but valuation was more than discounting the poor fundamentals. At the right price, any asset can be attractive. Unfortunately, we're no longer at that right price.

Stock market valuation is dependent upon future corporate earnings, and I'm not exactly painting a rosy picture for earnings. To be sure, earnings will not continue to fall at the pace of the last few quarters. We will even see some good growth in earnings on a year-over-year basis as we anniversary the atrocious bank number of late 2008. However, with consumers retrenching and with capacity utilization at record lows, corporate earnings growth will be far from impressive. Even with strong earnings growth towards the end of the year, the aggregate level of earnings will remain far below peak levels for some time.

Here is the situation corporate America is facing. Volume (units) is under pressure as consumers and businesses pull back. In addition, few companies have pricing power in such an environment. As a result, revenue is under pressure. The one consistent bright spot in earnings last quarter was on the cost front. To their credit, companies have been quick to cut costs, but you can only cut so much fat before you're into the meat. It will be very interesting to see second quarter earnings numbers and second half projections from firms. I'll be keeping an eye on the revenue line and SG&A margins in particular. I suspect much of the low-hanging cost-cutting fruit has been plucked.

If this is correct, then not much has really changed when it comes to the earnings outlook since March. If earnings expectations are the same (as mine are), but prices have rallied 40%, then valuation is 40% more expensive. In other words, the U.S. stock market is 40% more expensive today than it was on March 9th. The rally was driven by a P/E multiple expansion rather than an improvement in the earnings outlook. This is precisely why I've been selling stocks in recent weeks and why I've had a difficult time finding new stocks to buy. And, it seems I'm not alone in this assessment. Corporate insiders have been unloading shares at a torrid pace in recent weeks, and companies have rushed to sell new shares during this rally. Corporate insiders sold $2.7 billion in June while purchasing only $90 million.

This government-induced rally could continue, but this is not a healthy market. The vast majority of the trading which is occurring is computer-driven. This is relatively little real investor demand. These are computers using trend-reinforcing algorithms to try and scalp profits by buying and selling vast quantities of shares in fractions of seconds. If/when this changes, this dynamic coupled with the lack of true investment demand could lead the market significantly lower.

There are other signs that this rally hasn't been healthy.

- It has been led by those companies with the worst balance sheets. The more likely your company was to fail back in February, the better your stock has done since March.
- Just like last fall, there is a very high correlation between various asset classes. On any given day, there is either a de-risking or re-risking taking place. If the stock market is up, then every other asset class seems to be up, except for the dollar and Treasuries. This isn't normal or healthy.
- In addition, volume hasn't been as strong as you'd expect for such a powerful rally.
- Furthermore, we're seeing much greater volume on down days than on up days.
- Also, investor sentiment readings have once again reached overbought levels.
- Finally, corporate executives wouldn't be taking advantage of the rally to bail out of their shares if they were convinced that the green shoots were real.

I'm also concerned that everyone seems to think that we saw the lows in the market back in March. The most bearish expectation seems to be that we might correct 5-10% from here before moving higher. It's always worrying to me when a strong consensus develops. It often proves wrong. I'm not saying that we definitely will make new lows, but I do believe there is a higher probability that we'll see those March lows again than most think.

Let's not forget that we saw a 50% rally during the Great Depression. So far, the path of this bear market has been eerily similar to that of the 1929-1930 period. That doesn't mean it must play out the same way. I just want to stress that the market has a way of doing what the fewest number of people expect. This is a good time to be a little paranoid.

Performance

I wrapped up last quarter's review with the following: "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."

And a strong rising market we had indeed. U.S. stocks climbed 10-20% over the quarter, depending on which index you track. Emerging market stocks were even stronger. China returned 35% in the quarter while India posted a nearly 60% gain. Investment grade bonds returned 1.65% for the quarter. I discussed the divergence between oil and natural gas prices in the last Bulletin, so the figures in the table below shouldn't be surprising. Oil climbed 40% for the quarter while natural gas barely budged.

Year-to-date, the U.S. stock market has posted a small gain (VTI), with some pretty good divergence between the Dow and the Nasdaq. Again, note the incredible difference between oil prices and natural gas prices.

Index/Market	Q2	YTD
S&P 500	15.22%	1.78%
DJIA	11.01%	-3.75%
Nasdaq	20.05%	16.36%
Vanguard Total Stock Market (VTI)	16.90%	3.42%
iShares China 25 Index (FXI)	34.49%	31.90%
Wisdom Tree India Earnings (EPI)	58.59%	52.86%
iShares Aggregate Bond (AGG)	1.65%	1.28%
Dow Jones Commodity Index (DJP)	12.38%	5.54%
DPDR Gold Trust (GLD)	1.00%	5.39%
Oil	40.65%	56.55%
Natural Gas	1.53%	-29.68%

Given that we did indeed experience a strong rising market in the second quarter, it's no surprise that most accounts benchmarked to the U.S. stock market lagged. Most of these accounts outperformed the DJIA but fell a little shy of the overall market (VTI). All accounts, including the most conservative, performed much better than the investment-grade bond market.

My view of any period's performance doesn't hinge solely on our performance versus our benchmarks. This quarter provides a great example of this. Although most accounts lagged the overall market modestly, I am very satisfied with our performance. Keep in mind, we generated near-market returns while selling into the rally, holding a decent amount of (and building) cash, adding short positions to portfolios (which hurt performance in the quarter), and being diversified beyond just U.S. stocks. In other words, our returns came with significantly less risk than the market.

2009 is off to a good start for us. Our more aggressive accounts are up 14-25% for the year versus 3.4% for the market. Our conservative accounts are also performing very well, though with somewhat more modest returns and even less risk (as should be the case). The investment climate is still volatile, and things can change quickly, but I'm pleased with our performance year-to-date and over the past year.

Portfolio Activity

As is my habit, I like to look at a few of the drivers of performance during the prior quarter and add a little color. Overall, our portfolio activity over the past quarter can best be summed up as a general de-risking. I stated last quarter that we would be reducing our exposure (risk) if the market continued to rally, and that's exactly what we did. Equity market exposure was reduced dramatically by the end of the second quarter, with some accounts actually being net short equities (a larger short position than long). The other notable change was an increase in our commodity exposure due to our accumulation of UNG (natural gas).

Given the prior discussion on performance, we must have had some good security performers in the quarter to have captured much of the market return with far less equity exposure. The strong performers can be broken into two groups – our international exposure and our high-beta names.

Two of our strongest performers were our Indian (EPI) and Chinese (FXI) positions. These were also two of our largest positions, with FXI accounting for 10% of many portfolios and EPI accounting for another 5%. These two country positions constituted the bulk of our international equity exposure. Fortunately, these two markets were the leading equity markets globally in the first half of the year. As you may have noticed, we sold all of our EPI position towards the end of the quarter as well as half of our FXI (in most accounts).

We began building our position in EPI back in January of this year (and added to it through April) when global markets were falling and after the Indian market had been additionally punished for the accounting fraud that was uncovered at Satyam (a large Indian technology company). It was a terrific buying

opportunity. At the time, I fully expected to hold on to this core position for a number of years. However, the global rally, eventual clarity on the Satyam situation, and an overwhelming election victory for the ruling Congress Party (see the gap up in May in the chart below), drove the Indian market significantly higher in a very short period of time (a good problem to have). We sold our shares in early June as I felt the market was getting ahead of itself. Many accounts saw a 100% gain in this position for the short time we held it. I'm keeping a close eye on India and hope to have the chance to own it again – at a more attractive valuation.

As for our Chinese position, the story is similar. China has been a core position for us. Although China with its strong balance of payments position is more fiscally sound than most of the rest of the world, a strong rally in the Chinese equity market coupled with some near-term concerns led me to reduce our position by half. Specifically, I'm concerned that the market is ahead of the fundamentals as China is still very dependent on exports which continue to falter. Also, it appears that a good deal of the increased lending encouraged by China's recent fiscal stimulus may have been directed into the stock market instead of business investment. Additionally, the quality of Chinese bank balance sheets is suspect, and there appears to be a real estate bubble underway in the cities. Finally, valuation is a concern. The average P/E ratio (price-earnings) for Chinese stocks has climbed to the 25-35 times level from 14-17 at the end of last year. This is a very rich multiple with little margin of safety. This had been one of our largest positions, and it's still meaningful. Should the shares rally a bit further, we may eliminate the position. Like the Indian market, I would like to own more China, but at a better value.

The other positions that performed very well in the quarter were our high-beta names. These are some of our smaller and relatively more risky positions. The best performers in the market last quarter were the most "drecky" firms, and this held true for us as well.

- Atlas Pipeline Partners (APL) climbed 103%. .
- Nabors Industries (NBR) and Patterson-UTI (PTEN) climbed 56% and 44%, respectively.
- Dryships (DRYS), one of the disappointments from the first quarter, was up 40%. It was sold.
- Vale (VALE), a large iron ore mining company, was sold for a gain of 42% in the quarter.
- Two of our junior gold mining stocks again performed well. Golden Star (GSS) and U.S. Gold (UXG) were up 40% and 30%, respectively.
- Our oil ETF (OIL) rose 33%.
- Petrobras (PBR) gained 34%.

As for disappointment, it may not be what you're thinking. Clearly, most of the short positions that were added last quarter are underwater so far, and therefore by definition, were bought too soon. I tend to be on the early side with most of my investments, and this has been no different with our short positions. Furthermore, when we own both long and short positions, it's very unlikely that they will all do well simultaneously. The key point is that the shorts are and have been serving their purpose, which is to reduce (hedge) some of our portfolio risk.

Actually, my biggest disappointment this past quarter was having missed shorting the long end of the Treasury curve. We had successfully entered and exited this trade (TBT) in December 2008 and January 2009, and I've been hoping for another shot at it. We had a very brief chance at the beginning of the quarter, but it was very brief, and I missed it. Fortunately, the recent rally in Treasury bonds has brought TBT back from its highs of early June. Should we have another stock market sell-off, we may get a good entry point yet again back in the low-$40's or better as investors flock to the perceived safety of Treasuries.

Outlook & Conclusion

The rally that we've just had has been a P/E multiple expansion rally. The fundamentals and the earnings outlook have not changed since March. So, we have to ask ourselves if we really want to pay 40% more for securities whose underlying earnings power hasn't improved in the middle of a global balance sheet recession. The actions I've taken in our portfolios and the preceding 7 pages should make my answer clear (the answer is no if you just skipped to this section). As far as I'm concerned, we're still in a secular bear market until proven otherwise. Rallies are meant to be rented, not owned. Buy-and-hold would have killed you last year, and it will probably hurt you going forward.

We're still in an environment in which all risky assets are moving in sync, both up and down. There are very limited benefits to diversification today, and this has implications for our short-term performance. Specifically, our commodity, gold, and currency positions should perform well over time and should ultimately provide some protection for us, but that isn't the case currently. Should the market roll back over, these normally defensive positions are also likely to decline. The long-term attractiveness of these positions outweighs this near-term short-coming, so we'll be keeping most of these positions. If anything, these are the asset classes I'm most likely to increase on a pullback. I still prefer hard assets to financial assets, in general.

As usual, I don't know where the market is headed in the short-term. What I do know is that we are not being adequately compensated to own most risky assets today. The risks to the economy and to asset prices are significantly greater than is generally recognized. As a result, we've taken the prudent step of locking in some gains and taking the risk level of our portfolios down significantly. If risky assets do decline anew, we will likely decline as well, but we should fare much better. Our cash, our fixed income, and our short positions will help cushion any blow. If the market continues to rally strongly, our defensiveness will hurt our relative performance. Wherever the market does go, a continued elevated level of volatility is likely to continue creating terrific opportunities for us.

I'll leave you this quarter with a note of caution. Most of what you hear and read about the economy and the markets is garbage. It's easy to get inundated with opinions and information, and it can be very hard to make sense of it all. If you just come away from this review with an understanding that we're in a balance sheet recession that will need a good deal of time to correct, you'll have a better understanding of our economy and the risks we face than 95% of the people on CNBC. Here's a tip I give to investment professionals and do-it-yourself investors: Don't watch CNBC, don't believe the headlines, and don't listen to a market expert's opinion unless you're familiar with his or her track record. I've just saved you hours of your life each week. Enjoy your summer.

Best,

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7/3/09