ASPERA REVIEW

Intelligent, Independent Investment Management

2Q10 Portfolio Review: What Goes Up…

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.

"Sometimes I wonder if the world is being run by smart people who are putting us on or by imbeciles who really mean it."

Mark Twain

The last four quarters remind me of the parable of the tortoise and the hare. I'm sure that you're all familiar with the story. A hare teases a tortoise for not day trading, investing in momentum stocks, watching CNBC, or buying Apple products. The tortoise challenges the hare to a competition to see who can generate the best 5-year portfolio performance. The hare readily accepts, and the contest begins.

The hare loads up on a sexy portfolio of emerging market stocks, Greek and Spanish bonds, bank stocks, the Euro, and Chinese real estate. The tortoise keeps a good chunk of cash under his mattress but buys some precious metals and mining stocks, select cheap energy stocks, some hedge positions, and inflation-protected bonds.

The hare proceeds to build a big lead and figures that he has the race all locked up. Rather than waste his time sitting at his quote machine, he builds a high frequency trading system to automatically place his trades. He also levers up his portfolio using margin to boost his return even further. Then, he buys a private plane and flies off to the Riviera to hone his baccarat skills and to do what rabbits do best.

While he's away, the markets turn south, and the hare's portfolio takes a beating. The tortoise's approach, however, weathers the storm and continues to generate steady returns without incurring much risk. The hare receives an e-mail notifying him of an impending margin call due to the collapse of his portfolio. He tries to call his broker using his new iPhone but can't get any reception because his sweaty, furry paws are interfering with the phone's antenna.

Ultimately, the hare's portfolio is wiped out, and the tortoise wins the competition. The hare is banned from the investment industry and takes a job at a dog track as the lure. The tortoise goes on to eradicate world hunger, cure cancer, and marry the hare's wife. At least that's how I remember it.

The key takeaways are:

1. Our recent focus on wealth preservation paid off last quarter.
2. Moms should be in charge of storytelling.

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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Paul And The Keynesians

The smart people or imbeciles running the world are suddenly realizing that global growth is indeed slowing once again. That this slowdown is accompanied by the rolling off of massive global stimulus measures seems nothing more than a coincidence to these intelligent imbeciles. Trillions of dollars have been spent and promised with little to show beyond a larger debt burden.

As this slowing has become more evident, the Keynesians (including most economists, politicians and leprechauns) have taken to the offensive once again, led by Nobel Prize winning economist, Paul Krugman. It should be noted that Mr. Krugman did NOT win his Swedish statue for his work on how to steer an entire economy. His prize was for "*his analysis of trade patterns and location of economic activity*." [I'd like to emphasize that Paul only has one more Nobel Prize than I do, so the race is still close. Importantly, I've bowled one more perfect game than Paul, and since a perfect game and a Nobel confer the same degree of economic analytic legitimacy, I feel more than qualified to challenge him on macroeconomic matters.]

Paul and the Keynesians (possible rock band name?) have their knickers in a bind these days because some governments are finally starting to act responsibly. Granted, it took the bond market choking off credit to these governments, but nevertheless, we're starting to see more concern about unsustainable deficits and debt -- from many European countries in particular. These countries are cutting spending (very good), reducing benefits (very good), and increasing taxes (not good) to help close their deficits. Makes sense, right?

Ah, not in the world of the Keynesian. If you're a Keynesian and you have a headache, you slam your head against the wall. If that doesn't work, well, you do it again but harder. You keep slamming your head against the wall until you fall unconscious and can no longer feel your headache, thereby conclusively proving that the cure for a headache is slamming one's head against the wall.

These perpetual one-trick-pony sheetrock denters are arguing that governments should aggressively be adding even more stimulus now that the global economy is again weakening. According to the Keynesian view, the stimulus so far was critical in keeping the global economy from collapsing into another Great Depression. They view the battle as half won. Now, they claim, we must rally the troops and once again commit to further massive borrowing and spending to prevent the economy from collapsing into another Great Depression…again.

Fortunately, two things are occurring now that make it somewhat harder for our leaders to continue this dangerous prescription. In some countries (particularly in Europe), the bond market has finally responded to the massive debt burdens that these countries carry and their increasing risk of default. As a result, bond investors are demanding higher interest rates to compensate them for the risk. This, in turn, is forcing politicians to finally get their budgets under control since they don't have the funds to pay a higher interest rate on a rising debt burden.

The second important development is voter revulsion, which we're experiencing now in the U.S. More Americans seem to be realizing that the path our leaders (Democrats and Republicans) have had us on is the road to ruin. Trillions are spent with nothing to show for it but a rising debt burden that will be foisted upon the backs of our children. Politicians may not know much, but they know which way the wind blows. Recent elections around the country as well as the difficulty that the Democrats have had in extending unemployment benefits yet again (already at an absurd 99 weeks for some) are evidence that voters are getting increasingly fed up with D.C. The upcoming mid-term elections should be interesting.

Big Ben To The Rescue?

I'll say it yet again. You don't fix a debt problem by borrowing. Politicians and Keyensians fear recessions although recessions should be embraced for what they are – the business cycle's enema. They serve to purge the excesses and misallocations built up over years of boom. As I've highlighted in the past though, this is not your typical business cycle. This is the ending of a massive multi-decade debt bubble. There is

no painless way out of this. Debt must be paid down, restructured, or written off. Some combination of the three will continue to play out in the coming years. It can be dragged out as it has been in Japan, but it can't be prevented. The more Washington tries to forestall it, the worse it will be.

There now seems to be some realization and understanding that new massive government spending isn't likely to happen. IF the fiscal gravy train is indeed sputtering, whether voluntarily or not, then this will prove a drag on growth going forward as existing stimulus measures continue to roll off (a good thing). We've just seen the most recent housing credit end, and the housing market slowed dramatically. Furthermore, although there is little discussion about this, tax rates are scheduled to increase next year as the Bush cuts are allowed to expire. This will be another drag on the economy. In such a world, the pressure will once again fall on the shoulders of Ben Bernanke and the Fed.

Ben will increasingly feel the heat in the coming months as evidence of a slowing becomes even clearer. Ben is going to feel immense pressure once again to "help" the economy by further easing monetary policy. I would be very surprised to see Ben sit on his hands at this point while the economy weakens and risk spreads widen. It would essentially be an admission of failure. It's no secret that Ben believes that the Great Depression was in large part caused and exacerbated by too tight a monetary policy on the part of the Federal Reserve. Let's ignore for the moment that this is completely wrong (Note that Ben and I have the same number of Nobel prizes.). All that matters is that he believes it, and his actions to date are completely consistent with that view. For him to retrench now would be to admit that he is about to make the same mistake that he has vocally accused the Fed of the 1930's of making.

So, the most likely course will be for Bernanke to once again loosen monetary policy. With short-term interest rates already at zero, this tool is gone, but Ben could still spend trillions buying securities from the private sector as he already has. He could also manipulate the interest rate that the Fed pays to member banks on their reserves at the Fed. Ben has demonstrated an ability to think outside the box and stretch the letter of the law, and I have little doubt that he is contemplating other avenues that we may not have even considered.

IF Ben does increase stimulus, it will have to be on a massive scale to have any type of impact. This would be a terrible decision, but it's unfortunately the one I expect we'll see as Ben is very unlikely to admit defeat or ignorance at this stage of the game. He has already picked his horse. The only question is how much he'll wager. Another massive round of quantitative easing will mean further debasement of our currency. This will continue to send false pricing signals throughout the economy and result in a further misallocation of capital as well as rolling asset bubbles. The only good news is that the value of gold should be even more appreciated in such a world.

Performance

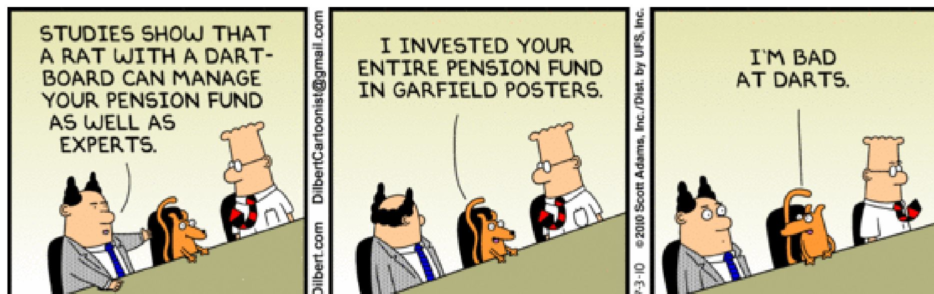
The swan regressed back into an ugly little duckling last quarter. Global equity markets more than gave up their gains from the first quarter as risk aversion once again gripped the world. The U.S posted a decline of 12% over the last 3 months, bringing the year-to-date return for the index to -7%.

Index/Market	2Q10	2010
S&P 500	-11.86%	-7.57%
DJIA	-9.97%	-6.27%
Nasdaq	-12.04%	-7.05%
Vanguard Total Stock Market (VTI)	-11.80%	-6.76%
Vanguard International Stock Index (VGTSX)	-13.33%	-12.01%
China - Shanghai A Share Index	-22.88%	-26.86%
Wisdom Tree India Earnings (EPI)	-2.49%	3.08%
Emerging Markets (VWO)	-9.87%	-7.34%
iShares Aggregate Bond (AGG)	2.93%	3.93%
Dow Jones Commodity Index (DJP)	-5.57%	-10.93%

DPDR Gold Trust (GLD)	11.68%	13.39%
Oil	-7.56%	-3.73%
U.S. Dollar (UUP)	5.29%	8.58%

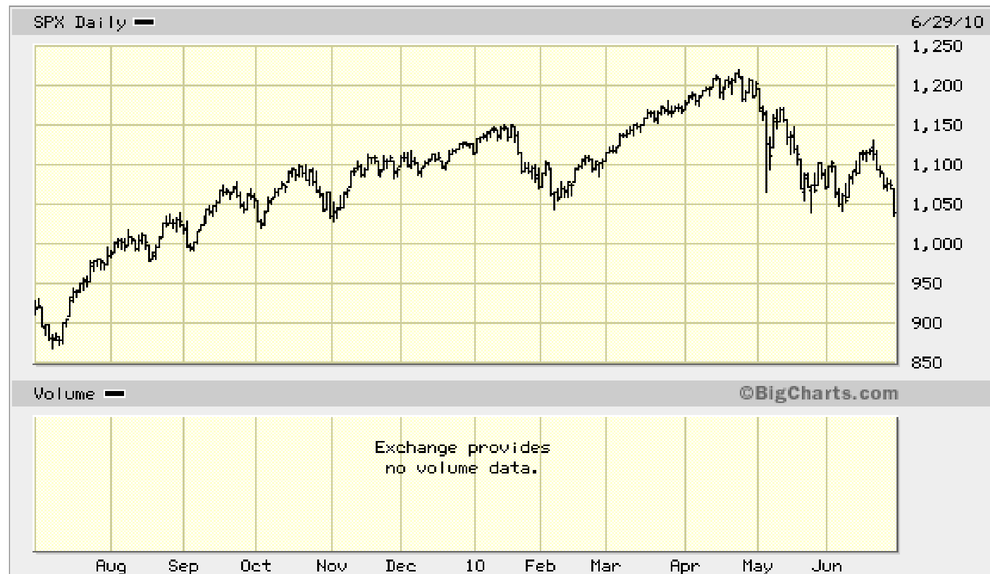
International markets have fared even worse this year, led by China which is in bear market territory with a year-to-date return of -27%. Commodities have also rolled over in recent months as the likelihood of slowing global growth is finally being recognized.

Fortunately for us, gold was the star performer last quarter, posting an 11% gain. As I've been discussing in recent months, gold is finally trading on its merits rather than simply tracking the performance of other risky assets. Gold is gradually once again being viewed as a currency and an altogether unique asset class (at least for the moment). There will continue to be pullbacks in the price of gold as there are in any healthy bull market, but the investment thesis for gold continues to unfold as I expected.



The other big winners last quarter were U.S. and German government debt as a flight to safety drove investors to the perceived relative safety of these two countries' debt securities. Once again, the deflation camp is claiming victory as Treasury yields have reached new lows. It will be interesting to see how the pressure for lower yields driven by a weakening economy matches up with the pressure for higher yields driven by further deterioration of U.S. credit-worthiness. I still expect that we're much closer to the end of the great bond bull market, but it still could take some time (measured in years potentially) before its ultimate demise.

The chart below shows the performance of the S&P 500 for the past year. As you'll recall, although our aggressive accounts posted 2009 returns that were in-line with the S&P 500, our performance was very much front-end loaded last year. We only captured a portion of the rally from late summer onward as we gradually increased our defensive positioning. The S&P 500 is now back to last September's levels. I warned that the market was likely to roll over quickly after peaking as little of the buying was "real". If you were fretting at all about missing out on some of those gains since last September, fret no more. They no longer exist.



Aspera Performance

We had a very good quarter, primarily due to the fact that we avoided the rout in global equity markets. Our continued lack of correlation with any mainstream benchmark was once again borne out, with most of our accounts posting gains in the 0-8% range despite the strong sell-off in global risky assets. Our more aggressive accounts performed best, as these accounts were able to hold more hedge positions.

Whereas our hedge positions were our worst performers in the first quarter, they served their purpose admirably these past few months. Our short of Research In Motion gained 38%, our short of Freeport-McMoRan (a copper play) was up 29%, and our short of XHB (homebuilders) posted a 15% gain. Our call option on the VIX index (a measure of volatility) was the star performer, with a gain of 225% while our VXX position (which tracks the VIX) gained 48%.

Our precious metals and miners were mixed. Gold and silver performed well, and our position in junior miner U.S. Gold (UXG) posted an 85% gain due to some good exploration results. Newmont Mining (NEM) was another winner with a gain of just over 20%.

Our two worst performers in the quarter, however, were also miners. Entrée Gold (EGI) fell 38% and Mines Management (MGN) declined 32%. Both of these positions are speculative securities and therefore highly volatile (as is UXG). Such strong volatility in these names is to be expected, as I've frequently cautioned. Entrée has very large reserves of copper in Mongolia, so EGI is a play on both copper and China, both of which have been under pressure recently. I expect EGI to be a long-term winner, and we're likely to be boosting this small position before long if the weakness persists. MGN is a very junior silver mining firm. I remain bullish on the metal and will likely be taking advantage of the recent decline to boost our exposure.

Two other notable laggards were TBT and PBR. TBT is an ETF which tracks longer-term Treasury yields. With yields falling again on this latest flight to safety and signs of economic weakness, TBT performed

poorly in the quarter. I've held off building this position during this most recent Treasury rally, but my patience is wearing thin. Petrobras (PBR) is the huge Brazilian oil company with immense offshore deepwater assets. They've been hurt recently by the BP spill, the decline in the price of oil, and an impending share offering.

Trading Activity – Closed or Reduced Positions

Research in Motion (RIMM)

We covered our short position in RIMM at a nice gain near the end of the quarter following a disappointing earnings report from the company (very good for us). The stock was down over 10% following the release due to weak revenue and shipments. This position (and our earlier PALM short and puts) was largely predicated on increased competition coming from Apple's iPhone and Google's Android. A market that RIMM had largely to itself is being aggressively targeted by every competitor. When we initiated our short position, RIMM's valuation wasn't particularly attractive either. I'm no less pessimistic about RIMM's competitive positioning, but with the stock now back near its level of March 2009 and with a reasonable P/E multiple, this isn't quite as compelling a short.

PowerShares Dollar Bullish ETF (UUP)

Near the end of the quarter we also sold our position in UUP, an ETF designed to track the performance of the U.S. dollar relative to other currencies. We bought this position last fall when the dollar was universally hated and oversold on a short-term basis. This was a tactical position which was a little difficult to buy given my long-term negative view of the dollar. The position recently hit our sell target due to the weakness in the euro and a flight to safety.

Trading Activity – New or Increased Positions

BP Equity and Bonds

Perhaps I made a mistake in adding Diamond Offshore and British Petroleum securities to our portfolios in recent weeks. Had I realized that owning them would compel me to watch hour upon hour of Congressional hearings on the oil spill, I may have chosen a less painful path and simply shot myself in the foot with a nail gun.

Like most Congressional activities, the hearings on the BP spill were a colossal circus. The first hearing I watched involved the senior executives of some of the largest oil companies currently drilling in the Gulf of Mexico. The competing CEOs asserted that they were very focused on safety and that they would have made different decisions than BP on the Macondo well. Did we really need a hearing to learn that? What else could they possibly say? "Offshore drilling is insanely dangerous, and BP did a bang up job. We probably would have made an even bigger mess of things ourselves." C'mon.

The most entertaining part of the show was the disclosure by Chairman Markey that the Gulf of Mexico emergency response documents for each of the companies were virtually identical. The fact that each of these documents cited walruses as one of the marine mammals studied was particularly interesting since walruses haven't lived in the Gulf for millions of years. Fortunately, the documents stopped just short of referencing remediation efforts for oil-soaked unicorns. The CEO of ConocoPhillips did finally admit that this oversight was embarrassing and that these documents should be updated more frequently. Yes, they should probably be updated at least once every million years.

The hearing with BP CEO Tony Hayward was even less informative but more interesting. As a concerned citizen, it was a maddening spectacle to watch as Hayward provided no definitive answers. As a newly-minted BP stock and bond investor, it was a masterful spectacle to watch as Hayward provided no definitive answers. What was most amusing was the expressed frustration and disgust of most of the committee members with Tony's noncommittal responses. But how could they possibly have been surprised? Many of them are lawyers themselves. Did they really expect Tony to show up and admit to

gross negligence, sign the company over to Obama, and promise to donate the proceeds from his own future blood plasma sales to spill victims? It was as though they expected Tony to admit to intentionally blowing up the well and then using the corpses of baby seals in the "top kill" attempt at plugging the well.

This was meant to be a public flogging, and all parties played their role. The legislators were provided an opportunity to vent their anger and prove to their constituents that they are pro-environment (who isn't?), and Tony sat and quietly took his beating. Then, when it was over, all of the self-satisfied committee members hopped into their gasoline-powered cars and drove home to their natural gas-cooled homes with asphalt-shingled roofs and oil-based house paint, filled with petroleum-based products such as plastic bottles, aspirin, linoleum, disposable diapers, antihistamines, candles, pillows, crayons, perfumes, toothpaste, carpeting, and curtains.

Nothing which has transpired since my last Bulletin (detailing the BP and DO purchase) has been terribly surprising. The company has temporarily halted its dividend as I expected and agreed to place $20 billion into a fund for claims. The latest cap on the well has proved somewhat effective and the relief wells appear to be on track. At the moment, attention is largely focused on the hurricane season and the impact that a big storm could have on efforts to plug the well.

The bottom line remains that I do not expect BP to go bankrupt from this disaster. Of course, there's some probability that they could, but I consider the likelihood fairly small. As I stated in the last Bulletin, BP is worth more alive than dead. If claims are to be paid, the company needs to remain solvent.

Assuming that the company does survive, the equity can be valued using a dividend discount model. As with any valuation model, the assumptions employed are critical. I tend to opt for conservative assumptions, thereby building in some margin of safety. I continue to assume that the dividend is gone for a few years although the company is claiming it has only been suspended for the balance of this year. I then assume that the dividend is reinstated at 60% of its most recent level. Assuming less-than-historic growth in the dividend and a modest discount rate will get you a fair value for the equity today in the mid-$50 range.

Our initial position in BP equity at the time of the last Bulletin was fairly modest. Since then, we've added to the position as the stock has fallen further. In some accounts, we've added BP bonds. The bonds that we've been buying mature in 1-6 years and have yields in the 7-10% range. The bonds are more senior than the equity and are therefore safer in the event of a bankruptcy.

There is no objectivity when it comes to BP in the press these days, and that's partly what has created this intriguing investment opportunity. BP has been universally condemned, although it appears that this may have been poor decision-making on the part of just a few people out of the tens of thousands who work at the company. There is little recognition of the $3 billion that the company has already spent on the clean-up or the $20 billion that the company has committed to setting aside for claims. There is no recognition that nobody wants this spill stopped more than BP. There is little recognition of the tremendous experience or dedication of those who are now endeavoring to plug this well.

I continue to expect that the relief wells will eventually be successful. BP securities will rally a bit once this occurs. The ultimate cost of the cleanup and liability won't be determined for years, and the cost to BP will also be spread over many years. The cleanup will continue and ultimately be relatively successful. BP will likely sell some assets, equity, and/or debt to help fund its obligations. An acquisition by Exxon or Royal Dutch is always a possibility if shares don't rebound.

Lessons will be learned from this and better mitigation and containment plans will evolve. Insurance costs for drilling in the deepwater will soar, ironically enhancing the competitive position of the largest companies like BP. Instead of Too Big To Fail we'll end up with Too Little To Afford The Insurance. The CEO (and possibly others) will be replaced by someone squeaky clean who doesn't possess a British accent.

The short attention span of the nation will eventually shift to some news of celebrity infidelity, the drama of how many quadzillion dollars LeBron James will earn next year, or war with Iran. BP will make good on its bonds and will eventually reinstate its dividend. Everyone who is now so certain that BP will fail will

eventually be buying BP stock quite a bit higher and claiming that they knew all along that BP would survive. Of course, I could be wrong.

I'm happy to report that I've still received no complaints on our BP purchases (as it should be). Should you still be harboring any moral discomfort, may I suggest the following:

1. Consider it a hedge. You can root for them to fail, but at least you'll get some reward if they don't.
2. Should we make money on these securities, you can always donate your gains to any of the many worthy charities helping to clean up the Gulf region.
3. As a shareholder, you get to vote on proxy issues. Feel free to vote against management.
4. Come judgment day, you are fully entitled to put the blame wholly on my shoulders. Taking a hit for you in the hereafter is one of my lesser known services.

Diamond Offshore (DO)

As detailed in the last Bulletin, we took a position in DO at the same time that we bought BP. Since then, the Obama administration's decree to ban offshore drilling for six months was overturned in court. The administration, however, is in the process of addressing the issues raised by the court in a new decree. As I expected, there has been an outcry over the lost jobs and revenue that this is causing, and the administration is now challenged with walking the line between helping the Gulf economies and looking tough on Big Oil. These rigs will not sit idle indefinitely. They will eventually be put back to work outside the Gulf if this ban is not lifted in the coming months. The administration has softened its tone in recent weeks and has made a point of recognizing the economic impact of this ban. DO should prove a solid contributor to our portfolios over time, and I'm excited to have been able to buy it on the cheap.

RDSA

We recently added a position in Royal Dutch to some portfolios. Royal Dutch has fallen over 15% in recent weeks as the entire oil space has been under pressure. RDSA has a very nice 6.5% dividend yield and will ultimately benefit from higher oil prices over the next decade. The dividend should continue to grow over time, providing a nice inflation hedge.

This position is similar to VZ and our energy L.P.s. They are hybrid securities that I view more like a bond than a stock. The price of these securities will vary and these fluctuations will affect portfolio market values, but I pay them little regard. My chief concern with these names is the security and growth of the dividend.

Portfolio Positioning

We remain relatively conservatively positioned with our precious metals position remaining our most significant bet. Our trading of late has been more bottoms-up driven than macro oriented. UUP and RIMM both reached our sell target, while BP and DO are special situation stocks that had recently suffered substantial declines. Although my view of the markets is still far from sanguine, the net effect of our trading in recent weeks has been to very modestly increase our net long exposure.

Our precious metals names will continue to be a key driver of performance. While gold and silver (the metals themselves) have decoupled from general risk assets, the mining stocks continue to struggle for direction. At times they track the price of silver and gold while other times they follow the equity market. I suspect that they'll continue to primarily take their cue from the equity market, so they're likely to be a drag on performance in the near-term should the market keep falling.

In general, we should continue to lag the market should it rally strongly. Conversely, we should be reasonably well protected in the event of further erosion. We'll remain fairly conservatively positioned until and unless we're able to find enough attractive long opportunities. We'll occasionally find special situations like DO and BP, but it will most likely take a significant decline in market values to generate the kind of broad-based attractive valuation which will once again lead to us being more aggressively positioned.

Strategy and Outlook

When the cash-for-clunkers program ended, car sales cratered. With the most recent housing credit expiring last month, real estate activity has plummeted. The evidence is clear that our economy has been subsisting on borrowed and printed money during the past 18 months. By spending trillions, the powers-that-be were able to manufacture a feeble economic rebound. Their hope was to engender enough confidence in the economy and markets that firms would hire, investors would invest, banks would lend, and consumers would consume. The real story of the last 18 months is just how little demand Washington was able to generate despite such a herculean effort.

We're now past the point of peak stimulus dollars. This will prove a drag on GDP. Furthermore, the recent strength of the dollar will crimp our exports and the earnings of many large-cap firms. We're also at the beginning of the large wave of Option ARM resets that I've mentioned in the past. Housing has not yet bottomed. Lumber (down 35% since mid-April) and copper prices have fallen dramatically in recent months. Europe is adopting austerity measures in order to get their budgets under control. This will certainly crimp global demand. The Chinese have continued to take steps to rein in their urban real estate bubble, and it just might be working as recent signs point to a slowing in China. Tanker rates for dry commodities have rolled over hard in the past couple of months. State budgets and pension plans are a mess. Tens of thousands will have soon exhausted their unemployment benefits. We're fast approaching midnight and the economy is turning back into a pumpkin. The key issue to watch in the coming months is whether the Fed once again waves its magic wand.

Our strategy remains consistent. We'll take advantage of opportunities as we find them, and we'll shun risk that we're not being adequately compensated to take. Should the market continue lower, you should expect to see a gradual reduction of our hedge positions and a gradual increase in our net long exposure. The further the market falls, the more aggressive our positioning will become.

Should the market turn around and head back up towards its highs, you should expect to see us reduce some of our long positions and gradually rebuild our hedge book. The ingredients for a new secular bull market are notably absent, so any rally is most likely another cyclical move within a secular bear market. This bear market will run its course, but it may still take a number of years, and the path will be bumpy. So long as we face the tremendous headwinds that currently exist and so long as valuation remains uninspiring, our overriding concern will be wealth preservation. We will, at the same time, look to take advantage of the volatility to generate solid risk-adjusted returns in a low-return world.

This phase of the market is very much like a game of musical chairs. The music plays for a while and everyone happily makes money. Once the music stops, thousands of investors are left without a chair and are forced out. The process keeps repeating until everyone has either lost or simply quit the game. For the time being, we'll continue to play the game, but we'll dance from the comfort of our chairs.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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