Aspera Review

Intelligent, Independent Investment Management

3Q2010 Portfolio Review: Quantitative Pleasing

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"The ability to foresee that some things cannot be foreseen is a very important quality."

Jean Jacques Rosseau

I recently returned from visiting family in Southern California. In true contrarian fashion, I flew out on September 11th. I figured that would be the one day when airport security would really be paying attention. I wasn't disappointed. After thoroughly examining my driver's license, the TSA agent at the Raleigh airport looked up and wished me a happy early birthday. He may have been 10 days early and he may have said it with the enthusiasm of a depressed mime, but he was clearly paying attention.

Just as I was beginning to question my aversion to the TSA, it was time to fly back home. This time at the security checkpoint the TSA agent examined my driver's license thoroughly and, instead of wishing me a happy belated birthday (one mere day), he informed me that my driver's license was now expired. Out of the fire of airport security and into the frying pan of the DMV. Happy birthday to me.

Next, our diaper bag was flagged for a hand search. I understand that it isn't politically correct to profile, but the odds of a white, young(ish), American-born family with no known ties to any group more threatening than the ASPCA, sneaking a bomb on a plane in a diaper bag to blow themselves and their baby up strikes me as fairly remote. We should be profiling the depressed mimes.

Maybe my expired driver's license was a red flag. If I didn't take the time to renew my license, perhaps I wasn't planning on being around to need said license. Perhaps a father's bias has led me to mistake my daughter's militant jihadistic sneer for an adorable smile. Nevertheless, the diaper bag was hand-searched twice and then passed through the scanner once again. Next time we fly I might just be tempted to leave a loosely-wrapped "dirty bomb" in the diaper bag.

I don't get to visit southern California very often, but when I do I always feel like I'm visiting a host of foreign countries -- part northern Mexico, part southern Mexico, and part coastal Mexico. Whatever part of Mexico it feels like at any time, we had a terrific visit with my wife's family. They own a wonderful restaurant and a beautiful home with a gorgeous view of the Pacific and Catalina Island. Yes. I knew this before I married my wife, but it had ~~almost~~ nothing to do with my proposing.

Besides visiting family, one of the reasons I enjoy traveling is that it further removes me from the “noise” of the markets and everyday life. I already do a pretty good job of minimizing this noise on a daily basis. I don’t have cable. I don’t Twitter. I had texting turned off when I bought my phone. I don’t want a phone that’s smarter than I am, and it was already a close call with two tin cans and some string. I don’t Facebook (is that a verb?). The iPad strikes me as a very expensive Frisbee. I have nothing against technology. I own an electric can opener, and I can’t see going back to the manual version.

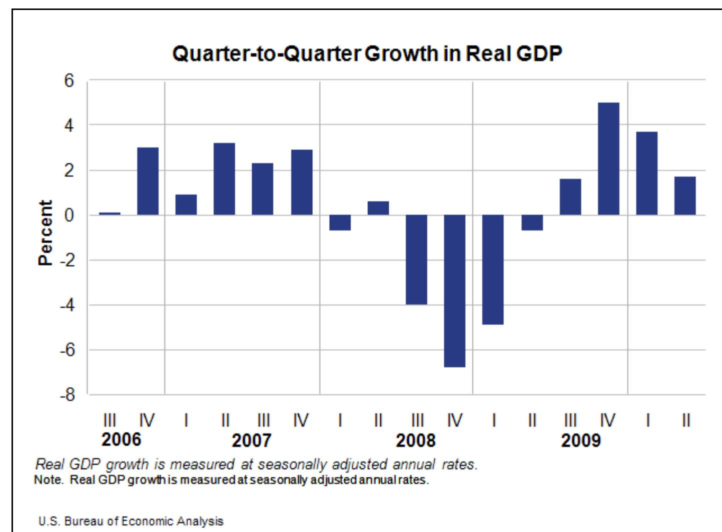
So, I successfully further extricated myself from the noise of everyday life during our trip. I found myself more in-tune with my thoughts and my fellow man although I was struck by just how difficult it is in California to distinguish between the hip and the homeless. Each morning I walked to the local Starbucks for my coffee, and each day I would offer my spare change to the disheveled folks who stumbled in looking tired and cold (it was only in the 60’s in the early morning). It took a week of insults and glares before I realized that the targets of my charity were successful movie producers, internet moguls, and real estate investors (just kidding – they don’t exist anymore). I probably should have been tipped off sooner since they were each carrying one of those fancy new Frisbees.

The Economy – Private Sector Demand Still MIA

The constant hope, obfuscation, and spin surrounding the reporting and analysis of economic data since early 2009 has been consistent and amusing. The powers-that-be have a vested interest in maintaining the status quo, and their game plan seems to depend upon convincing the populace that things are better than they actually are. They would make terrible lifeguards. They see a man drowning in the ocean and tell him to just relax and enjoy the sunny day. Make no mistake. The economy remains quite weak and is greatly lagging the typical post-recession recovery path.

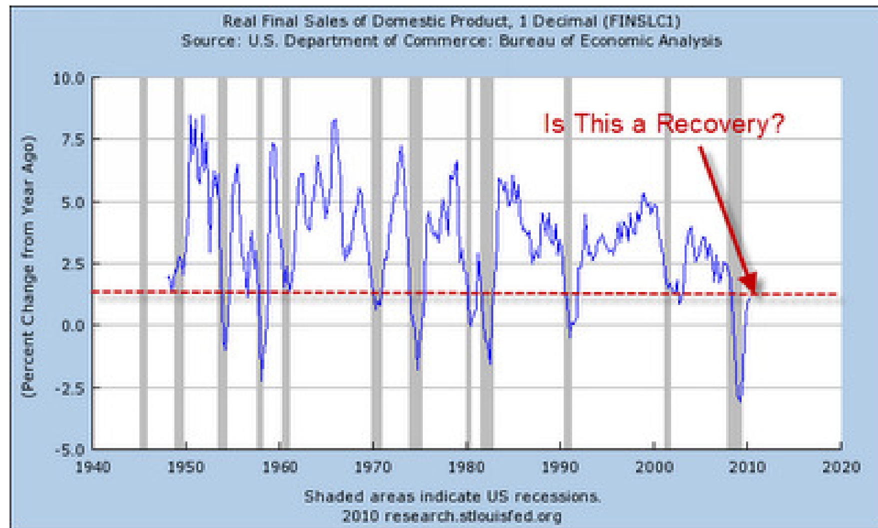
One of the themes I’ve been banging on for the past 15 months or so is that this much-hyped economic recovery was not real and would not last. It was not real in the sense that it was almost completely dependent upon government stimulus, the occasional boost from exports thanks to a weak dollar, and inventory replenishing.

The evidence of slowing growth became all but impossible to ignore during the past quarter. As you can see in the chart below, GDP growth accelerated nicely from the fourth quarter of 2008 through the fourth quarter of 2009. This shouldn’t have surprised anyone given the trillions in stimulus thrown at the economy. The only surprise is just how small the response to such a massive mobilization actually was. So far in 2010 we’re seeing a rapid moderation in economic growth. Again, this should not have surprised anyone, as the wearing off of the stimulus was sure to prove a drag.



Furthermore, the impact of inventory rebuilding is no longer boosting the official numbers. When inventory is rebuilt following a slowdown, that increased inventory adds to GDP. Following the crisis in 2008-9, firms were desperate to slash inventory as demand collapsed. This dragged GDP growth down during early 2009 but set the stage for a rebound in late 2009 and 2010. This goosing has effectively run its course.

Because of the variability of inventory in the GDP report, it's very important to keep an eye on real final sales (see the following chart), which strips away the impact of inventory to provide a better view of real activity. Real final sales never fell as steeply as GDP in late in late 2008/early 2009 nor rose as strongly over the last year. In a typical recovery, we would be seeing real final sales growth at or above 5%. We haven't come close to those levels.



With consumption accounting for roughly 70% of economic activity, a real unemployment rate of 17%, a looming tax increase, and a still massive debt overhang, we're unlikely to experience strong and sustained economic growth for some time still. Without question, the last thing we need to see is a rebound in economic growth being driven by increased borrowing at any level.

The Return of Quantitative Easing (QE)

Quantitative easing. I just love the term. It sounds so official and important and academic and mathematic and scientific yet gentle and zen-like. How can you not like quantitative easing? Everyone these days seems to love it. If my wife and I have a son I just might name him Quantitative Easing Bell. Unfortunately, by the time my unborn son reaches high school, the world will be all too aware of just how counterproductive and destructive quantitative easing is, and my yet unborn son will be subjected to hypothetical daily ridicule and wedgies.

Washington loves to come up with names for bills and policies that make them sound wonderful, and quantitative easing is no different. Quantitative easing is nothing more than monetary inflation and dollar devaluation. Note how the actual descriptive terms sound so much more negative. No one could get away with coming out and saying, "We're about to embark on a new policy of monetary inflation and dollar destruction." But, call it "quantitative easing" and the crowd roars for more.

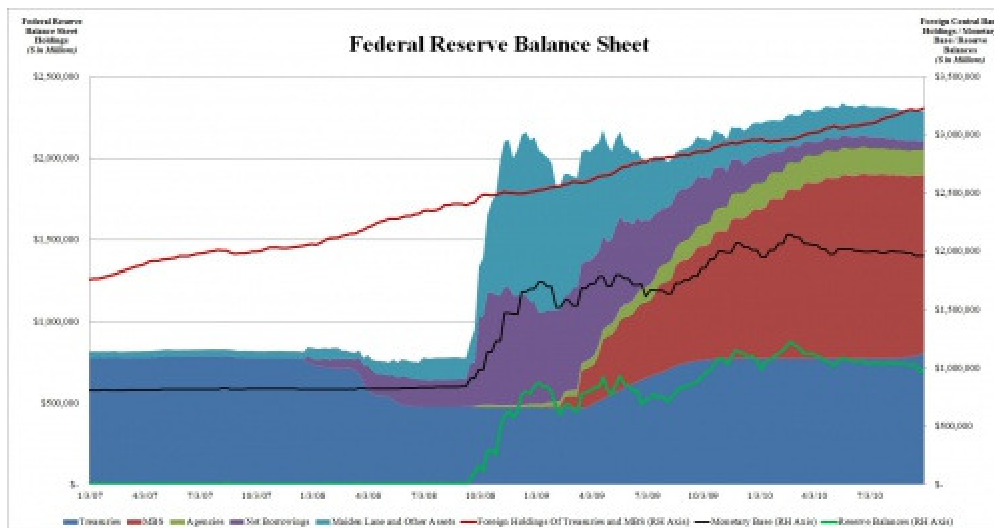
In last quarter's review, I wrote the following:

> *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 didn't take long. The clear weakening of economic activity in recent months gave the Fed the cover it needed to initiate its next round of stimulus, billed as QE Lite. With this, the Fed is reinvesting the interest and maturities (principal) from its securities portfolio back into Treasury notes and bonds. Merely weeks ago, the Fed was publicly discussing its exit strategy, but that talk is now off the table. Instead, the Fed has telegraphed that it's likely to resort to another bout of massive (at least another $1 trillion) monetary inflation and dollar devaluation (I'm sorry -- quantitative easing) should the economy weaken. Well, the economy has been weakening, and the market has zipped ahead in the expectation that this stimulus is imminent.

You can see below that the Fed massively increased the size of its balance sheet when the crisis first hit. This was QE 1. It could be argued reasonably that this was necessary to address the liquidity crisis which existed at the time. Today, however, there is no liquidity crisis. There is plenty of cash and credit in the system relative to demand. The issue we face is one of solvency, not liquidity. Sound monetary policy would call for removing the liquidity that was added to the system and letting interest rates rise back to market levels, but the Fed hasn't practiced sound monetary policy for a long time. Instead, we're very likely to soon see the slope of the following chart jump yet again as the Fed conjures new money to buy even more assets from the private sector.



The Fed is resorting to blatant money printing because it is rapidly running out of tools to manipulate monetary policy. Short-term interest rates have already been driven to zero. Now, they hope to drive longer-term rates down. They would have us believe that their goal is to get banks to lend, thereby spurring the economy. Well, Ben is either lying or he's stupid. In this particular instance, I'm going with lying. I believe the Fed knows that consumers are generally unwilling, unable, and/or unqualified to borrow more. The Fed also knows that the banks are generally much more concerned with rebuilding their capital (safety cushion) than growing their loan portfolios. The data proving this comes from the Fed itself.

So, the Fed's primary concern is not really with spurring the economy by lowering rates. This is just the spin being used to deflect and distract from its real intent, which is twofold. First, they aim to boost asset prices in order to rebuild confidence and encourage increased spending due to the wealth effect. Second, they want to devalue the dollar in order to make American goods and services more affordable internationally.

This current policy of quantitative easing is pure desperation. The Fed is once again pursuing a faulty and short-term focused policy which will create massive imbalances and dislocations. Ben has the foresight of

a moth. The Fed is playing a dangerous game of manipulating asset prices, exactly as they did prior to the internet bubble and housing bubble. In recent years, the Fed has managed to stoke bubble after bubble by keeping interest rates too low and money too readily available. The Fed has been an abysmal failure in spotting bubbles but a tremendous success in creating and fostering them. This time is no different. Sadly, it will end very badly yet again.

Competitive Devaluation

One of the other major risks I've been discussing for some time is that of competitive devaluation. This issue has recently become front-page news across the globe with everyone including Japan, Brazil, Thailand, Peru, Switzerland, South Africa, China, Korea, Colombia, and Russia taking steps to actively devalue and/or talk down their currencies. We've now moved well beyond the cute bickering between the U.S. and China which has been the focus of currency disputes in recent years.

In a world with ample demand and strong balance sheets, this wouldn't be such a heated issue. The fact that countries are climbing over one another to reduce the value of their currency is powerful evidence that global demand remains subpar. With an excess of manufacturing capacity and labor and insufficient domestic demand in much of the world, hopes for growth are being pinned on increasing exports.

It should be obvious, however, that everyone can't increase exports at the same time. Some countries have to import. For decades now, the U.S. has been the chief global importer, but our growth has slowed, and we can no longer increase our consumption through borrowing. Further, Obama has made it clear that one of his goals is to double exports over 5 years (not going to happen barring serious dollar devaluation). So, even the world's chief importer wants to increase exports.

There is one extremely easy way to boost your exports in the short-term – devalue your currency. If one or two countries do this, it can work for them. When everyone wants a weaker currency, however, the stage is set for resurgent inflation and trade wars. Countries will simply take turns devaluing their currencies to give a short-term boost to their economies. This has the potential to spiral out of control.

The U.S., which possesses the world's reserve currency, is the big dog in this fight. If we are determined to boost exports through dollar destruction, it will happen. The only thing that the Fed has successfully done consistently since its founding in 1913 is destroy the value of the dollar. The value of the dollar has plummeted 95% in that time. I think the Fed does a horrendous job when it comes to most of its functions, but I never doubt for a moment its ability to manufacture inflation and dollar devaluation. There are tremendous risks out there today which could wreak havoc upon the global economy and markets. This one has to be near the top of the list.

The End Game

We have a weakening economy, an expectation for further massive monetary stimulus, a tremendous debt bubble, and the very real prospect of a currency war. The boring market environment I've been hoping for isn't likely to arrive for a while.

The stock market had been following the improving economy higher throughout the final three quarters of 2009. Again, this was largely due to the massive stimulus provided by Obama, the Congress, and the Fed. It probably isn't a coincidence that the market has largely been meandering in 2010 given that economic growth has been declining steadily in the face of still high debt levels and unemployment. The stimulus provided a short-term boost (at a substantial long-term cost), but it didn't address the underlying issue of debt. In fact, it exacerbated the debt problem and prolonged the time it will take to adjust back to a truly healthy economy.

With the economy weakening, we're once again facing a massive intervention on the part of the Fed. Interestingly, we seem to be in a phase in which all news is good news. Good (or not as bad as expected)

news sends risky assets higher, and bad news increases the odds of more quantitative easing which sends risky assets higher.

The current rally in risky assets is clearly tied directly to the implementation of QE Lite and the rhetoric surrounding and expected enactment of the next massive round of quantitative easing. The market isn't rallying because the economy is improving and healthy. It's rallying precisely because the economy is deteriorating, which will compel the Fed to print money.

I can't stress strongly enough just how dangerous the environment is becoming yet again. Our stock market is being driven by computer algorithms trying to scalp pennies on millions of trades rather than by long-term fundamental investors. Volume has been declining in the market over the past year, insiders are again selling hand over fist, and we've seen cash outflows from equity mutual funds consistently for 6 months. The economy is weak, unemployment remains high, housing is still a mess, valuation is unattractive, we still have a massive debt bubble, demographics are a major headwind, public pensions are massively underfunded, and we may be on the cusp of a trade war. Aside from that, it's a terrific time to buy financial assets!

Here's what I don't know. I don't know how long this easing/stimulus will serve to boost risky assets. I don't know if the markets are about to top out again or if we're off to the races one more time. Clearly, to some degree, the market has priced in some substantial easing on the part of the Fed already. In fact, we may well see a sell-off once the Fed formally announces the program. I simply don't know. No one does.

Here's what I do know. I do know that I don't care about what I don't know. I have zero intention of gambling on the markets and chasing the hot money around the globe. I don't care if the markets get silly or stupid and run up despite unattractive valuation and fundamentals. I do know that the Fed is doing nothing to actually address the underlying problems. I do know that we're not getting paid to load up on risk in the current environment. I do know that I have no desire or intention of getting blown up once this latest misplaced euphoria wears off. I do know that the markets will soon come to the realization that the Fed cannot save us. I do know that balance sheets need to be repaired. I do know that I plan to sell more of our long positions should the markets keep climbing. I do know that money printing and a trade war are very bullish for our precious metals positions.

The endgame is coming, though the timing is uncertain. The Fed is not bigger than the market in the long-term. At some point, we will have our Greek moment when the bond market realizes that our bankrupt government will only be able to pay its bond obligations with inflated (devalued) dollars. This is likely to be when the debt death spiral will begin unless we address it voluntarily first. The debt burden here and throughout much of the developed world is far too great to withstand higher interest rates. Until that time, the current low interest rates are actually encouraging governments to put off addressing serious debt reduction efforts. We have the subprime lending crisis occurring at the sovereign level. This is Ponzi finance of the highest order.

If we remain on our current path, there will be massive economic blowback in the form of rising interest rates, rising interest expense, massive budget pressures, and ultimately an acceleration in the debasement of the dollar and monetization of the federal debt as the Fed and Treasury move beyond their current gentle petting to full-on relations. There is still time to preach and practice abstinence, but the Fed's urges are growing stronger, and we may not be able to hold Big Ben back much longer. The game is over once the market finally demands higher interest rates as compensation for increased credit and inflation risk.

There is an important question which the bulls struggle to answer. If everything is so wonderful and risks are truly low, why does gold keep making new highs? If the economy and debt bubble were truly on the mend and if monetary and fiscal policy were sound, we would see gold plummeting. Ignore the pundits. Ignore the press. Ignore the politicians. Ignore the Fed. Watch gold.

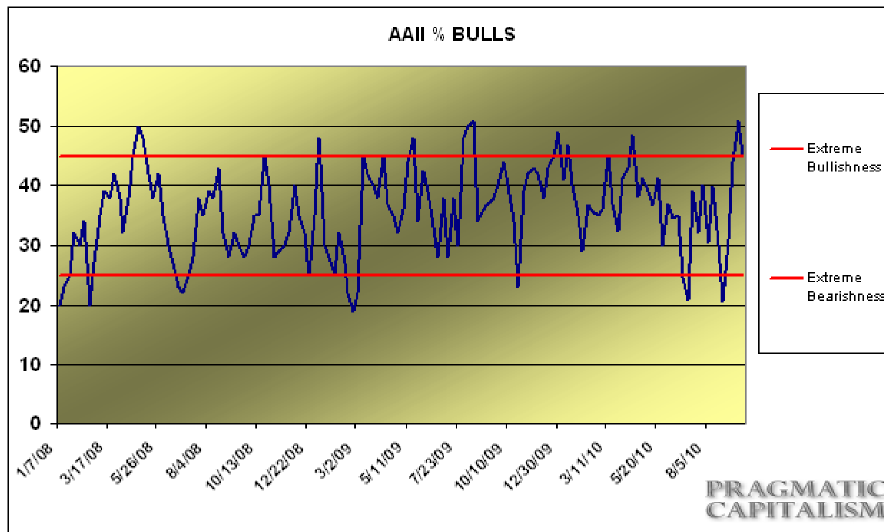
Let me re-emphasize what I wrote last quarter:

> *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

It was risk-on and full steam ahead last quarter for virtually every asset class except the U.S. dollar. When we left off at the end of the second quarter, the markets were at their lows for the year and concern was growing that the market could fall sharply. You can see in the two charts below that sentiment was quite bearish at the end of the second quarter, and few stocks were trading above their 50-day moving average. These often contrarian measures effectively called a short-term bottom in the market. Today, both of these measures are pointing to excessive bullishness. We'll see if they mark a short-term top in the markets.



The markets have been moving in a monolithic fashion with risky assets rising and falling in tandem. This is neither normal nor healthy. Traditional diversification does little to mitigate risk in this type of market. Money is either flowing into risky assets or fleeing for safety en masse. There isn't much middle ground for the time being.

In a rising and risk-hungry market, the most volatile asset classes tend to perform best, and this is what we saw in the third quarter. Commodities and emerging markets led the way with very strong double digit

returns. The dollar was a huge laggard, dropping nearly 9%. For the year, the real standout has been gold, which has climbed 19%, continuing its 10-year bull market.

Index/Market	3Q10	2010
S&P 500	10.72%	2.34%
DJIA	10.37%	3.45%
Nasdaq	12.30%	4.38%
Vanguard Total Stock Market (VTI)	11.05%	3.55%
Vanguard International Stock Index (VGTSX)	17.90%	3.75%
China - Shanghai A Share Index	10.65%	-19.07%
Wisdom Tree India Earnings (EPI)	15.91%	19.48%
Emerging Markets (VWO)	19.66%	10.88%
iShares Aggregate Bond (AGG)	1.31%	5.29%
Dow Jones Commodity Index (DJP)	12.33%	0.05%
DPDR Gold Trust (GLD)	5.12%	19.20%
Oil	5.29%	1.37%
U.S. Dollar (UUP)	-8.86%	-1.04%

Aspera Performance

We had a solid quarter with most accounts registering gains in the 5-7% range. Performance was unusually consistent across all portfolios, with our most aggressive and conservative portfolios all posting similar returns. Given the still modest levels of risk we're taking in our portfolios, this is very strong risk-adjusted performance. For the year, most of our accounts are up in the 5-10% range. Again, this has been achieved with very modest risk exposure. This compares very favorably to most asset classes as well as the performance posted by most hedge funds.

Our hedge (insurance) positions performed exactly as they should have in last quarter's strong market – poorly. As I mentioned above, there is little risk mitigation available from diversifying across the traditional asset classes. In such an environment, we'll continue to use shorting, options, cash, and special situation securities to protect our portfolios.

We had a few non-hedge laggards as always, but there were no big negative surprises in the portfolio during the quarter. Our most disappointing names were our shorts of Freeport Copper (FCX) and Pre-paid Legal (PPD) which underperformed the market advance. Our short of long-term Treasury bonds also performed poorly as the promise of unlimited Treasury purchases by the Fed and renewed deflation concerns helped drive bond yields lower.

On the flip-side, we had plenty of strong performers which offset our hedges and cash position. Our best performers were in the precious metal and energy sectors, not surprising since most of our long positions are in these two sectors.

Leading the way were some of our more speculative precious metals positions. Extorre Gold Mines rose 73% last quarter, driven by the strength in gold prices as well as takeover interest in another mining firm located nearby. Our call options on SLV (the silver ETF) climbed 72% due to the price of silver (and our SLV position) rising 17% in the quarter and approaching a 30-year high. Entrée Gold (EGI) was another stellar performer, registering a 55% jump. Entrée announced some good exploration results during the quarter. Mines Management (MGN) also performed well for us during the quarter, climbing 25%. Our gold/silver ETFs also posted nice gains with GDXJ (junior miners) climbing 22%. As I often stress, all of these mining-related names are very volatile. We will see pullbacks in this space from time to time.

Some of our energy names also posted strong results in the quarter. BP was the best performer with a gain of 42%. Our purchase of BP bonds was rewarded with gains of 10-20%. Fortunately, events with the Gulf spill have played out largely as I predicted right down to the CEO being replaced by someone without an English accent. Our recent purchase of Royal Dutch (RDSA) during the height of the BP crisis has also

performed well so far with the stock up 20% last quarter. Patterson-UTI (PTEN), one of our land rig positions, rounded out the strong performers with a 32% increase.

Trading Activity – Closed or Reduced Positions

Agnico Eagle Mines (AEM)
We shuffled some money around within the precious metals sector during the quarter. A few of our names reached their sell targets and were sold, including AEM. We bought AEM in December of 2009 and January of 2010 at prices between $55 and $58, after the stock was punished for disappointing Wall Street with start-up issues at a number of new mines. We recognized this as likely a short-term issue for a strong company with great assets. With the most recent rally in gold and equity prices, AEM hit our sell target of $70. The security was a tactical position which provided exactly what we like – a nice return with low risk.

Newmont Mining (NEM)
We sold our entire position in Newmont as well toward the end of the quarter due to the run up in the share price. As this entire group has performed well of late, we need to be sensitive to our increasing exposure to the metals (due to appreciation). The sale of Newmont helped to bring our exposure back down. NEM was added in 2008 and 2009 at prices between $35 and $50.

Golden Star Resources (GSS)
GSS had been one of our star performers. GSS is a junior gold mining firm with operations predominantly in Ghana. The junior gold miners are very risky firms as they are constantly in need of funding and are typically still in the exploration phase. The fact that Ghana isn't exactly a bastion of stability adds even more risk to GSS. Fortunately, we were paid very well to assume this risk. Most of our GSS shares were bought in early 2009 at prices in the $1.00 to $1.30 range. We sold our holding in mid-August at roughly $4.70.

Exeter Resource Corp (XRA)
XRA has been another one of our stars. Shares were purchased during the height of the panic in late 2008 and early 2009 at prices ranging from between $1.45 and $2.50. Furthermore, EXGMF was spun out of XRA back in March, thereby reducing the value of XRA shares. With shares flirting with the $7 level in early September, we rebalanced our position back to a more comfortable weighting.

Brookfield (BIP)
Toward the end of the quarter, we sold our position in BIP as the security hit our sell target. This was one of our higher-yielding investments, but the run in the stock as well as our desire to lower portfolio risk made it a good sale candidate.

Bunge (BG)
BG belongs in this and the next section as it was purchased on July 29th and sold on August 5th for a quick 15% gain. The stock was punished when the company issued disappointing earnings, but the nature of the miss was short-term, and the company operates in a very attractive sector (agriculture). The drubbing of BG provided a nice long-term opportunity. That long-term opportunity lasted for all of 7 days as the stock immediately began rebounding. Apparently others quickly realized that the stock reaction was overdone given the firm's strong long-term fundamentals. This is a sector I'd like to have more exposure to (we have in the past), but recent acquisition activity has driven prices and valuation up.

VIX Call Options
We sold our VIX calls toward the end of August. The price of these options had pulled back since the end of the prior quarter, but we still posted a nice 75% gain.

Trading Activity – New or Increased Positions

Silver Standard Resources (SSRI)
Although gold, silver, and mining stocks generally did very well during the quarter and made up some of our best performers, there were some notable laggards in the sector, and we took advantage of them. On the same day that we were selling GSS at its 52-week high, SSRI was just a couple of dollars (13%) away from its 52-week low. With silver looking more attractive than gold on a relative basis and with SSRI trading near its lows, this struck us as an attractive opportunity.

Mines Management (MGN)
Mines Management is a very early-stage speculative company attempting to re-open a silver/copper mine in Montana. The stock, which had been north of $3.00 per share earlier this year, had fallen as low as $1.50 during the quarter. We took advantage of that weakness to boost our exposure to the name.

Minefinders (MFN)
We've held shares of MFN in a few accounts for some time and took advantage of recent weakness to boost our position and add the name to more accounts. The stock was recently punished on news that a tear in one of its leach fields would hamper earnings in the near-term. This is likely to be resolved before too long, and the company is continuing mining operations in the meantime.

Hewlett-Packard (HPQ)
We haven't been very active in the technology space for…well, most of the last decade. The recent dip in shares of Hewlett-Packard has provided an interesting opportunity. Shares sold off from near $48 down to $38 back in early August on news that CEO Mark Hurd was being let go following a sexual harassment claim and the filing of inaccurate expense accounts intended to keep the relationship with the accuser secret. There are plenty of interesting questions surrounding the firing. Why did HP hire a former soft porn actress and reality-TV star for corporate meet-and-greets? Did Hurd seriously not sleep with her? How can he receive a $40+ million severance package for lying? Who do I have to harass for that kind of money?

These are interesting and perhaps disturbing questions but not terribly relevant. Hurd is gone, and HP is huge. HP can certainly run on autopilot for a while as the new CEO gets up to speed. At $38, HP was trading at about 8.5x this year's earnings. I'm not taking a lot of risk when I buy a large financially solid business at 8.5x earnings. The stock can always be a dud, but at least I have a very nice margin of safety. Once the market realizes that HP is much more than Mark Hurd and assuming the new CEO doesn't royally muck things up, I'd expect to see a rebound in the shares.

Nordic American Tanker Shipping (NAT)
We added NAT to more accounts during the quarter as the stock approached its 52-week low. NAT owns tankers which ship oil throughout the world. The company has maintained a pristine balance sheet and has done a good job of managing cash. The company strikes a good balance between paying dividends when day rates exceed operating costs and increasing the size of its fleet when it can do so on an accretive basis to earnings. Dividends will be lumpy as they depend on fluctuating day rates, but I expect this security to generate a solid total return from these levels.

Proshares UltraShort 20+ Year Treasury ETF (TBT)
TBT is a bet that longer-term Treasury yields will rise. With the Fed actively buying Treasuries at the moment, yields have fallen fairly significantly once again, and this position has been hit accordingly. We took advantage of the weakness to add to the name. At some point, Treasury yields will head quite a bit higher, and this security should perform well. The tricky part is the timing as the Fed may be able to keep rates lower for longer than many expect. For this reason, I've been careful not to increase the size of this position as quickly as I'd otherwise like.

Tesco Corp (TESO)
Tesco is a small-cap oilfield service stock which I've highlighted in the past. This has been a very volatile stock, bouncing between $10 and $15 per share for most of the past year. It has been a somewhat frustrating name in that it has come tantalizingly close to our sell target on a few occasions only to retreat

20-35%. The stock is a very attractive purchase at the $10 level which is where we added to it during last quarter's decline. The stock has already rallied 20% from those levels.

Frontier Communications (FTR)
We acquired our initial position in FTR as part of a sale of assets from Verizon to FTR. FTR paid for the acquisition with shares of its stock (the value of our VZ shares fell by a like amount). This left us with a fairly small position in FTR and required a decision to either sell the shares altogether or make it a "real" position. After researching the name, we decided to beef it up for our more conservative accounts given the company's cash flow and high dividend yield. The stock has performed well since then and is rapidly closing in on our sell target.

Portfolio Positioning

Precious Metals
Our most significant bet remains on precious metals, as it has for the past decade. It sure doesn't feel like it's been ten years since gold bottomed out near $250 an ounce. It's always interesting to see the evolution of an asset class from hated to tolerated to accepted to embraced to hoarded. Gold is beginning to be embraced once again as a must-own asset class. Granted, there are still many very vocal and well-known gold bears out there who continue to warn of an impending crash in the price of gold, as they have for the last 10 years. Today, however, few central banks are selling gold while a number are actually increasing their gold reserves. Some of the best known and most successful hedge fund managers have established significant gold positions. More and more investors have begun to turn to gold to help protect their wealth from the impending ravages of money printing and currency devaluation.

We are somewhere in Phase 4 of my Idiot/Genius cycle when it comes to precious metals. Fortunately, it's a genius phase. We've been in Phase 4 for some time, and I have no idea how long we'll remain here. Though many still view gold as being in a bubble, a bubble phase has yet to begin, and there's certainly no guarantee that one will. As I emphasized in my Bulletin on gold "All That Glitters…", precious metals are a hedge against political incompetence and monetary mismanagement. I can't think of a better way to describe our current situation with quantitative easing back in force and a currency war heating up. So, we'll continue to hold a substantial precious metals position as long as our leaders remain intent on driving us off a cliff. We'll finally sell our entire precious metals holdings when one of two things occurs. Either gold prices will enter a mania phase with gold (and silver) more than doubling from current levels, or the authorities will realize the error of their ways, rein in deficits, and protect the value of the dollar.

Should we enter a mania phase, I can guarantee you that I will not be holding out for every last dollar of gain, largely because of the fact that I have no idea just how high prices can ultimately climb. In a bubble, I'm sure they'd climb higher than I would imagine. You should expect to see an orderly exit from our positions as prices climb if a bubble does develop. You will be asking how I could have sold so early and left so much money on the table. You'll be wondering how someone who has been so right for so long (I can't say that about too many things, so humor me) about gold could have possibly sold so early. Such is the life of a risk-sensitive contrarian. This would be a high-class problem that I hope we get to endure.

In the meantime, so long as the bull market in the metals remains intact, we should expect pullbacks from time to time. After the recent climb to new highs, a pullback would hardly be surprising. These pullbacks tend to shake out the weak hands and move the metal to longer-term investors. These pullbacks will negatively affect our performance in the short-term, which is of zero concern to me. More importantly, they tend to offer good opportunities to bump up our holdings in this space in those names which get unduly hit.

Yield
Yield securities have done well as investors continue to lower the bar in terms of what they view as an acceptable yield. This will prove to be a costly mistake for them at some point, but until then, investors desperate for the perceived safety of bonds are flocking to the asset class.

We haven't ignored yield, particularly for our more conservative clients. Our yield plays have focused on TIPs, high quality short-term corporates, high-quality dividend-paying equities, and limited partnerships.

We also added BP bonds during the height of the Gulf crisis. Fortunately, all of these have performed very well.

I have no intention of adding (non-TIP) bond funds to our portfolios. A few accounts still have some exposure to these, and you should expect to see what remains of them sold in the very near future. Current yields simply don't offer enough of a risk premium to justify owning them. Once rates start heading higher (which could be months or years away), bond funds will be crushed. I don't know when this will begin, but I have no intention of rushing through the door at the same time as everyone else.

We will continue to keep an eye out for special situations like the BP bonds. These don't come around too often, but I won't hesitate to add them if we're being adequately compensated for the risk we take.

Energy and Agriculture
Hard assets remain a focus for us. When we've added risk to the portfolio in recent years, it's typically been in the hard asset sectors such as metals, energy, and agriculture. These should provide some protection against currency debasement, and the supply situation of many commodities remains rather bullish.

Special Situations
The other key area of portfolio exposure is what I term special situations. Currently, our positions in HPQ, BP, DO (Diamond Offshore), and RDSA (Royal Dutch) fall into this group. These are securities we own due to unique company-specific or event-specific issues. BP, DO, and RDSA were all purchased after substantial declines following the BP well blowout. HPQ was added following the canning of its CEO. These types of names can perform well regardless of what the market does. I'd like to find more of these.

Strategy and Outlook

Trying to predict short-term moves in the markets is a silly game. I was recently asked at a gathering what I thought the stock market would do during the fall. Of course, I told the truth which is that I have no idea. Frankly, if I knew in advance what every economic release would say and exactly what the Fed would do, I still couldn't tell you how the markets would react over such a short period.

It should be clear that I have no intention of drinking the Kool-Aid should the markets continue to run on hopes of the magical QE 2 saving the day. One of the key tenets of my investment management practice is a focus on absolute returns and preserving wealth. Over the short term (less than 10 years) I have very little concern for what any particular benchmark or market is doing. My focus is on taking appropriate and attractive risks – not trying to mimic the market. I don't do stupid with my money, and I don't do stupid with yours.

So, if the 22-year-old physics Ph.D.'s with their fancy Frisbees and new math which drive today's market decide that their 1's and 0's are aligned for a move still higher, I will gratefully and gradually sell more of our long positions to them. After that, we will very likely start to beef up the short/put side of our portfolios if things really get carried away. Frankly, if it weren't for the near-term uncertainty created by QE, we would be more defensively positioned already.

Warren Buffet has become a bit of shill for Wall Street and the administration of late, but he has offered some timeless wisdom over the years. One of my favorite passages is the following:

> *Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.*

This is very much how I view market quotes. We can argue until we're blue in the face about how real or manipulated any market move may be, but what really matters is the price (and of course valuation) at

which we can buy and sell specific securities. If Mr. Market gets a little too greedy, we stand ready to sell. When Mr. Market is a little overly upset and depressed, we will happily buy his shares.

In general, we will maintain a heavy precious metals position so long as the global authorities insist on debasing currencies and increasing debt. We'll rotate between mining securities opportunistically, and we may also shift our emphasis periodically between the mining stocks and the commodities (gold and silver) themselves. We'll pare back our exposure as it grows too large and boost it again on the inevitable pullbacks.

Otherwise, we'll take advantage of the opportunities Mr. Market provides and keep an eye out for more special situations. Our hedge position will grow as valuations expand, and it will shrink as the market become more attractive. In other words, we'll keep doing what we've been doing with an eye towards managing overall portfolio risk effectively. In addition, you should expect to see some tax-loss selling during the fourth quarter in taxable accounts. In particular, we'll be repositioning our hedge positions to capture the unrealized losses which have accrued.

Recall our last Bulletin on secular bear markets. This current rally is hardly out of the ordinary, and it will almost certainly reverse. We will again swing from an environment of optimism and hope to fear and concern. As always, my primary job is to help ensure that you never end up dependent on the naïve generosity of some incredibly attractive and masculine out-of-state stranger visiting your local Starbucks.

Best,

Ken Bell, CFA, CFP
President
Aspera Financial, LLC

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