ASPERA REVIEW

Intelligent, Independent Investment Management

Fourth Quarter 2008 – Good News, Bad News

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

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No one knows who the phrase is attributable to, but some wise guy at some point in history uttered the words, "May you live in interesting times." I think we could all stand just a touch more boredom in our lives, at least as far as the markets go. 2008 brought us the collapse of the credit and housing bubble. Critically, the virulent spiral of declining asset prices and forced deleveraging brought about by the credit contraction led to a collapse of virtually every asset class as hedge funds, banks, mutual funds, pension funds, sovereign wealth funds, ponzi schemists, and individuals rushed to sell whatever liquid assets they could. About the only investments that performed well over the year were short positions, Treasury securities, and 2008 Beijing Olympic pins.

As a perfectionist and my own worst critic, I'm seldom content with any one year's performance. 2008 is no different. On the one hand, my conservative and risk-averse clients fared well. In addition, all portfolios outperformed the market over the year. On the other hand, as cautious as I was late last year and earlier this year, I failed to predict the severity and breadth of the deleveraging that ultimately occurred. It was amazing to witness assets being dumped with no regard to price or value in panicked efforts to reduce leverage and raise cash. I mistakenly expected some sense of rationality to remain in the market.

As I look back over the year, my biggest mistakes included:

- not having larger short/put positions in those accounts that permit them
- not paring back on the long-term, core, commodity holdings earlier in the year
- adding to core names a little too early

Not paring the commodity names a little earlier is my greatest regret, particularly because I agonized over this decision. I did ease out of a number of commodity names (such as AGU, POT, DBA, and UNG) on June 19th and 20th. The plan at the time was to continue easing out of these names as they moved higher. Unfortunately, if you look at the chart for each of these names, you'll see that they were pretty much already at their peak in late June. Had I started selling a couple of weeks earlier, we would have likely sold a bit more of these positions near the top.

The other mistake was starting to add to some core positions a little on the early side in the second half of last year. Wary of trying to catch a falling knife, virtually all of these purchases were small and incremental. The objective has been to gradually build these positions over time which is exactly what we've been doing. These are long-term core positions, and I have a great deal of confidence in them, but I still wish I'd been a little more patient given how far they've come in.

In fairness, I did a few things right in 2008. These include:

- benefitting from some short positions
- avoiding the disaster in financial and real estate names
- some timely currency moves
- placing a number of opportunistic short-term trades
- avoiding companies with excessive debt
- keeping decent "cash" levels through the year
- easing into core positions over the year

Fourth Quarter and Full Year Results

A lousy third quarter turned out to be just a prelude to a horrifying fourth quarter in which the major indices fell over 20%. Although we outperformed in the fourth quarter, our more aggressive portfolios were still in the red.

For the full year, the S&P 500 and the Vanguard Total Market indices fell over 38%. To illustrate what an indiscriminately terrible year 2008 was, even the esteemed Warren Buffett suffered a loss of nearly 32% and ridiculously had his investment acumen questioned.

Performance varied greatly for the full-year based upon client risk tolerance. Not surprisingly, the best performance was experienced by those afraid of their own shadow (I mean that in a nice way) while the more risk tolerant among us are a bit less enamored by our shadows. I'm happy to say that all portfolios performed better than the market in the fourth quarter and for the full year, but that's small comfort given the magnitude of market losses in 2008. The market is still likely to rise over time, so if we can outperform in good times and bad, we should do well over the long-term.

	Q3 2008	**Q4 2008**	**2008**	**from high**
S&P 500	-9.00%	-22.45%	-38.49%	-42.29%
Dow (DJIA)	-4.40%	-19.12%	-33.84%	-38.04%
Vanguard Total Market (VTI)	-8.94%	-23.34%	-38.35%	-42.45%
Nasdaq	-8.77%	-24.61%	-40.54%	-44.84%
Berkshire Hathaway	8.16%	-26.03%	-31.78%	-36.30%

Outlook

The question I get most often at the beginning of each year is, "What do you think the market will do this year?" Unfortunately, I have the same dull answer as always. I just don't know. Don't get me wrong. I can guess with the best of them. I can quote previous bear market P/E multiples, and I can dazzle with a mind-numbing analysis of what may happen with corporate earnings. I can talk about the possible impact of fiscal and monetary stimulus and heap on a bunch of manure about dividend yields and book value.

The fact of the matter is every bear market occurs for different reasons, and every one plays out differently. Just because the P/E ratio fell to 8x in a prior bear market doesn't mean that it has to happen again. Of course, it also doesn't mean that it can't fall even further this time. Focusing on the average length and severity of prior bear markets can be terribly misleading. We are in uncharted territory.

Although the ultimate bottom in the stock market is still unknown, I am finding some of the best opportunities in my career these days. These investments may continue to come under pressure for some time still, but they offer the type of long-term return potential one seldom encounters. We may need to be patient with these names, but I'm confident that our patience will be rewarded.

As for the economy, I expect a pretty dismal 2009. We're still in the midst of an incredible credit unwind. Ironically, our government leaders and Federal Reserve officials seem to believe that the cure for a bursting credit bubble is more and more debt. What we really need is for our government to just get out of the way and let the natural forces of capitalism cleanse the excesses that have built up over the past decade. Debt needs to decrease and savings need to increase. This would be incredibly positive for the long-term health of our country, but our elected officials have all drunk the Keynesian kool-aid and are loath to be labeled a "do-nothing" government. Obama and the Federal Reserve have made it clear that they will do everything possible to "save" us. Unfortunately, their efforts will simply postpone the recovery while further burdening our children with debt and inflating away the value of our dollar.

Despite the best efforts of our leaders, the natural forces at work in the economy will eventually purge the excesses and sow the seeds for future sounder growth. Much of the reportedly bad news that we read about daily actually bodes well for our future. The increase in home foreclosures is moving property out of the hands of people who can't afford it, helping to reduce debt levels, and increasing the personal cash flow of the foreclosed. The closing of businesses and employment losses, though painful in the near-term, are speeding the elimination of excess capacity which was built to supply the dangerous and unhealthy debt-created demand that has now disappeared. The dramatic decline in home building is helping to restore balance in that industry. A higher savings rate will rebuild consumer balance sheets and provide the capital for increased future investment. The government should welcome these adjustments rather than fear them.

One of the key questions is whether the government will succeed in halting this healthy correction currently underway. Over the last decade, the government has refused to let the market correct prior excesses. Instead, the Federal Reserve has repeatedly stepped in to artificially lower interest rates below market levels and encourage borrowing, and our President and Congress have thrown billions in federal money at the economy. Had they let the correction occur earlier it wouldn't have been as painful. I believe that the natural economic forces at work will correct the excesses and lay the foundation for sounder growth in the future. It will take some time, but the process is already under way. Unfortunately, the actions of our leaders are likely leading to the next round of imbalances. These include a Treasury bond bubble, rising inflation, and a depreciating currency. Our portfolios are positioned with these risks in mind.

Strategy

Rather than trying to guess what the market will do over the short-term, I'll be continuing to focus on undervalued asset classes and individual securities as well as the risks just mentioned. As I stated earlier, there are more terrific buys today than at any point in my career. That, of course, does not mean that these securities will rise immediately, but it gives a great deal of comfort to own securities that have a sound valuation and fundamental underpinning.

There are a number of themes that we will continue to focus on this year including the following:

Inflation versus Deflation

One of the key debates occurring presently is whether we will experience future deflation or inflation. We are clearly experiencing some level of deflation at the moment as asset prices have been collapsing and banks have been unwilling to lend despite being able to swap their toxic assets for Treasuries. The key question, however, is what will happen moving forward. As incompetent as I believe our government to be, I think they will prove extraordinarily competent in manufacturing inflation. They clearly have shown no concern for the debt or deficit and have made it clear that they will do everything they can to prevent deflation. Since they control the printing presses and the world's reserve currency, I have little doubt that they will ultimately succeed.

The only real question in my mind relates to the timing and cost of their "success." I believe we run a serious risk of experiencing an eventual sharp deterioration in the value of the dollar and/or a bout of serious inflation. I have no faith in the government's ability to responsibly and promptly mop up all of the excess liquidity they are and will be creating. To exploit this, we will keep a close eye on opportunities to increase our foreign currency exposure (we currently own the Canadian dollar and the Chinese Renminbi). I would anticipate increasing these positions (or adding other currencies) on any substantial dollar strength.

We also currently have a short position on the long end of the Treasury curve (betting that interest rates will eventually rise). In the short-term, the Federal Reserve can artificially keep rates low by printing money and buying long-dated Treasuries. This is essentially a ponzi scheme which must eventually collapse. The only issue is when. Printing huge amounts of dollars to buy Treasuries is likely to lead to dollar depreciation, higher inflation, and fewer “real” investors (as opposed to the Fed or speculators) willing to buy “risk-free” Treasuries without a higher yield.

Perhaps most importantly, we have a healthy gold exposure that I continue to add to opportunistically on pullbacks. As countries around the globe race to devalue their currencies and increase their fiscal and monetary stimulus, I would expect interest in gold and gold shares to continue climbing. On the supply side, the credit crunch and economic downturn are leading to less production and less investment in new mines. I expect gold and gold shares to remain volatile (silver as well) in 2009, but the metal appears to have the wind at its back.

Commodities

Although the near-term outlook for commodities is not particularly bright, the long-term fundamentals remain strong. It all comes down to supply and demand. Currently, as the global economy weakens demand is being negatively impacted, and this is what everyone is focusing on. What I believe most investors are missing, however, is the supply side of the equation. Falling demand is masking what will ultimately be a very tight supply situation for many commodities. Most “experts” believe that the prior run up in commodity prices was due primarily to speculation. Speculation certainly played a role, but it was not the primary factor.

Supply of many commodities was very tight heading into the downturn. In recent months, there has been a steady stream of news related to project cancellations and postponements in the commodity space. With commodity prices falling, companies are rapidly pulling back on expansion plans, reducing output at existing mines, and shuttering marginal mines/facilities.

I believe that this sector will be one of the leaders once the market finally bottoms. The “experts” will be very surprised at how quickly prices rise once demand starts to pick up again. We will continue to add exposure to this space, and I anticipate holding these positions for some time.

Increasing Exposure to Leveraged Firms

As we’ve started to see some signs of an easing (at least temporarily) in the credit markets, I’ve started to nibble at some companies whose balance sheets are less than pristine but could offer tremendous returns if credit markets continue to ease. I’m taking a basket approach with these names. No single position will be too large to inflict serious damage if I’m wrong. In fact, I would be surprised if one of these names didn’t eventually fail. Overall, however, I would expect the basket to ultimately provide significant returns.

Opportunistic Short-Term Trades

The majority of the shorter-term trades that we’ve placed have worked out well. Although I’d expect market volatility to moderate somewhat from last year’s levels, I suspect that volatility will remain well above the muted levels we had grown accustomed to prior to 2008. With emotion still ruling the day, we can expect to see dramatic short-term moves in individual securities. In 2008, we were able to exploit a number of short-term opportunities (on the long and short side) in names such as GOOG, WFR, QID, QLD, SSO, ENER, and FSLR. I’ll be keeping my eye out for similar opportunities in 2009.

Trading Range Market

Although I don’t pretend to know where the market is headed in the short-term, I fully expect that we will have more sharp bear market rallies as well as sell-offs, and we will react to these. At the margin, we will add long and reduce short exposure following/during sharp sell-offs, and we’ll reduce long and add short

exposure following/during the rallies. I will also keep an eye out for opportunities to short individual names although it becomes more difficult to find compelling shorts the further the market falls.

I truly enjoy working with all of you, and I appreciate the opportunity you've given me to do so. As always, feel free to contact me with any questions or concerns regarding your specific portfolio. Have a wonderful 2009.

Best,

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President
Aspera Financial, LLC

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