ASPERA REVIEW

Intelligent, Independent Investment Management

4Q 2012 Quarterly Review: Don't Fight The Fed…Or ECB…or BOJ…or SNB…

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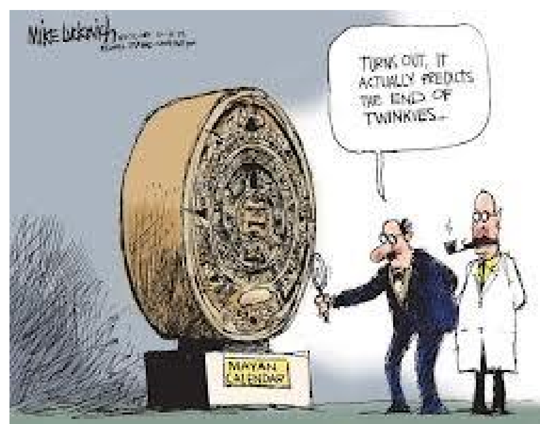
"We all know what to do, but we don't know how to get re-elected after we have done it."

Jean-Claude Junker (Prime Minister of Luxembourg)

It was another exciting quarter in this world of continued massive money printing and government borrowing, but the quarter began with some personal excitement. I exited September an avid if somewhat unaccomplished bicycler. A mere 10 days later I learned that my list of cycling achievements suddenly overlapped with one of the world's most celebrated cyclists. It turns out that neither Lance Armstrong nor I have ever won the Tour de France without using drugs. I'm trying not to let this go to my head, but this development has made me acutely aware and proud of all of the things I've achieved through non-achievement.

A mere two days later, we learned of more cheating and fraud. The author of the best-selling financial self-help book, "Rich Dad, Poor Dad", took a turn towards the "poor". Robert Kiyosaki was forced to file for Chapter 7 bankruptcy protection after a court found him guilty of failing to pay one of his earliest backers $24 million. Don't worry about poor Dad. His net worth is estimated at $80 million, and I predict he'll soon take another turn to the "rich" with a brand new franchise – "Rich Dad, Poor Bookkeeper".



While Lance and Robert may have thought that their worlds were coming to an end, December brought with it the potential ending of the world for the rest of us as well. Unfortunately, those who believed that the Mayans had foretold the ending of the world on December 21 proved to be wrong, so our politicians will still have to address the fiscal deficit and debt limit, Europe will still have to solve its debt problem and structural imbalances, and Japan is still left facing an unbelievably large government debt and shrinking population. On a happier note, my prediction that the end of the year would occur on December 31st once again proved spot on.

Fiscal Cliff – Will Somebody Just Push Them Over!?

Since the fiscal cliff has been blanketing the airwaves, I suppose I should make a comment or two. There are really three key issues at play. The fiscal cliff refers primarily to the unwinding of the “temporary” tax cut first enacted by Bush in 2001 and extended by Obama in 2010 as well as a cut in federal spending that was agreed to back in 2011. The other big issue that will soon be in the daily headlines is the fact that we’ve once again reached our debt limit.

Let’s take the tax issue first. The tax cuts enacted by Bush back in 2001 were scheduled to expire at the end of 2010. Those cuts were extended for two years due to the weakness of the economy back in 2010. They were then scheduled to expire as of December 31, 2012, but we’ve just seen the President and Congress address this part of the cliff by raising income, capital gains, and dividend tax rates on individuals with income over $400,000 and married couples earning over $450,000. Income tax rates will not change for those who earn less than those thresholds. The “temporary” Bush tax rates have now become the permanent Obama tax rates. But don’t think that you won’t be paying higher taxes in 2013. The 2% Social Security payroll tax holiday has been allowed to expire, so about 77% of U.S. households (about 155 million people) will see their tax bill increase this year.

The second part of the cliff consists of the spending cuts that were agreed to in the Budget Control Act of 2011. This was the bill that was passed in order to resolve the 2011 debt-ceiling crisis. Congress and the President agreed to increase the debt limit by a total of $2.1 trillion. One of the trade-offs was an agreement to cut at least $1.2 trillion from the deficit over the next ten years. If the Democrats and Republicans couldn’t come to an agreement on those cuts, they would be automatically implemented through the process of sequestration, meaning the cuts would be implemented automatically and would be evenly split between defense spending and discretionary domestic spending. Of course, Social Security and Medicare (the real problems) were exempt. Well, 2012 came and went with no agreement on spending cuts, so the automatic cuts (sequestration) were scheduled to take effect on January 1 of this year. Instead, Congress voted to kick this can down the road another 60 days to see if they could reach an agreement.

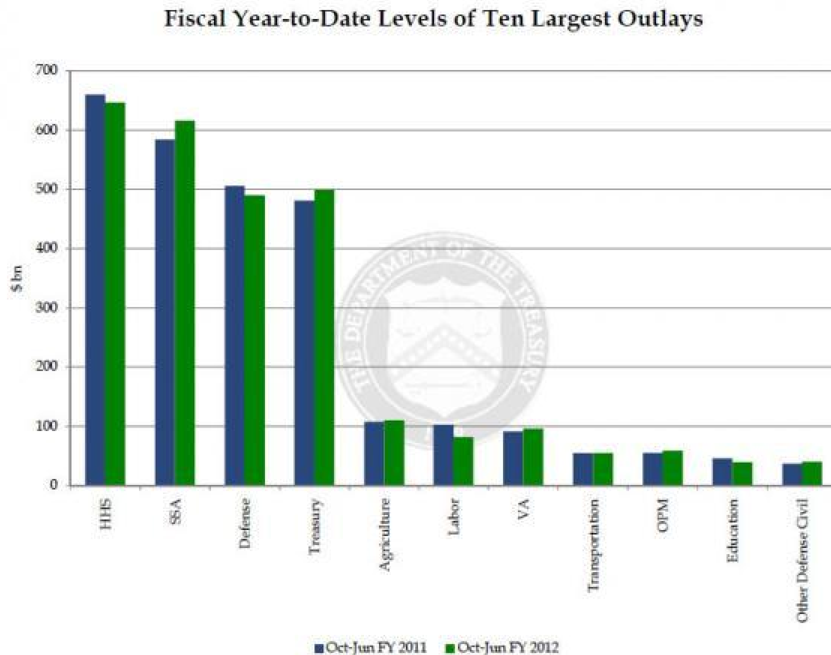
The debate over spending cuts is going to coincide with the need to increase our nation’s debt limit. We’ve already exceeded the limit, but the Treasury can shuffle money around for a couple of months to pay the bills. The markets may currently be celebrating a resolution to the tax question, but we’re headed right back into a tumultuous period when an incredibly divided Congress will need to reach some agreement on spending cuts and a debt limit increase. The drama is far from over.

That’s the background. Now, let’s see if I can explain how meaningless this fiscal cliff drama really is. It’s estimated that the just-passed tax legislation will provide $620 billion in revenue to the government over the next 10 years. That’s $62 billion per year. Our deficit is $1 trillion per year. In addition, the Congressional Budget Office has estimated that this tax deal will result in $4.6 trillion more in debt over the next decade relative to their baseline case of allowing all of the tax cuts to expire. Clearly, we aren’t making any progress on reducing the deficit through higher taxes.

The spending cuts that would be enacted IF sequestration goes into effect work out to $1.2 trillion over 10 years, or $120 billion per year. Our federal government spent $3.8 trillion in 2012. $120 billion works out to only 3.2% of the total annual spending that comes out of Washington. Congress and the President had 16 months to find a way to reduce their spending by a paltry 3.2%, and they couldn’t get it done. Ponder that for a moment. I can’t think of a much better definition of a dysfunctional government.

Furthermore, as I’ve discussed from time to time, the real problems lie with Medicare, Social Security, and defense spending. You can divide the annual budget line items into discretionary and non-discretionary spending. Entitlement programs, such as Social Security and Medicare, fall into non-discretionary. Interest expense on our debt is also non-discretionary. While defense spending is technically a

discretionary category, we haven't seen any truly significant cuts in defense spending in over 60 years. As I wrote last quarter, Social Security, Medicare, interest expense, and defense account for 83% of the 2013 federal budget. There can be no meaningful progress on our deficit and debt as long as our politicians refuse to address these major spending items. As you watch the debate on spending unfold in the coming weeks, pay attention to whether any serious and passable proposals are put forth to address any of these spending items. I confidently predict that we'll see none.



This is also a good time to remember that while everyone is focusing on the official federal debt of $16.4 trillion, the real horror lies in our off-balance sheet liabilities. You can think of this as the current value of the promises we've made to future Social Security and Medicare recipients. We've made huge and expensive promises without detailing where the money will come from to make good on those promises. Reasonable estimates on the size of this off-balance sheet obligation range from $50 trillion to over $100 trillion. There is absolutely no way that these promises will be honored. It is inevitable that age limits will go up, benefit amounts will decrease, means-testing will be applied, and/or qualification standards will tighten in the future.

In the coming weeks, we'll hear more about spending cuts and the debt limit. I would be shocked if anything substantive comes of it. With Medicare, Social Security, and real defense cuts virtually impossible to agree on, there is nothing of substance that can be done. We will have to endure weeks of political posturing, debate, and comedy, but in the end, the debt limit will be raised and some modest and largely irrelevant spending cuts will be agreed to, only to be rolled back once the next recession hits.

Quantitative Easing Round 4 (QE4) – Because Everything Clearly is Alright

From last quarter's Review:

> "Ben also announced that the Fed, if necessary, stands ready to purchase additional assets and employ other policy tools. In other words, the seeds of QE4 have just been sown with the announcement and future failure of QE3!"

Well, the wait for the next round of Federal Reserve stimulus proved even shorter. In September, the Fed announced that it would expand its purchases of mortgage-backed securities to $40 billion each month. At the time, the Fed was still buying about $45 billion of Treasury securities each month, but that program was scheduled to expire at the end of December. Instead of allowing it to expire, the Fed announced on December 12th that it would continue to buy $45 billion of longer-dated Treasury bonds. The news wasn't unexpected. This time, however, the Fed won't simultaneously be selling short-term Treasury bills to pay for it. In other words, the extra $45 billion associated with the new program will be conjured out of thin air.

They are again creating money and will be doing so to the tune of $85 billion each month. That works out to just over $1 trillion in one year, conveniently equal to the size of the federal deficit.

In addition, the Fed once again made a significant tweak to its playbook. They will now keep short-term interest rates near zero "at least as long as the unemployment rate remains above 6.5%, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well-anchored." So, we're now in a world where every economic release will be scrutinized in an interesting fashion. Signs of economic strength will bring us closer to the end of the Fed stimulus. With the markets very dependent on this flow of money from the Fed, we've reached a point where good economic news will likely be viewed as bad for both stocks and bonds.

The other Fed news actually just came out as I was writing this. The minutes from the December Fed meeting were released and showed a more divided viewpoint toward asset purchases (QE) than was generally perceived. A real debate about QE would be healthy and is long overdue. Should the Fed actually begin to tighten monetary policy (raise interest rates and start selling the bonds it has purchased), this would be a negative for the precious metals, so any genuine dissension in the ranks needs to be watched. However, I'm far from concerned at this point. For starters, the voting members of the Federal Open Market Committee (which votes on monetary policy) change every year, and 2013 will see a continuation of a dovish bias toward continued low interest rates and more asset purchases.

More importantly, I just don't see any viable exit strategy for the Fed. I strongly believe that the unprecedented stimulus by the Fed (and other central banks) has been the primary backstop for the financial markets. The rise in the equity market and the historically low yields on many bonds is due in large measure to Fed stimulus. If the Fed stops easing, I would expect a strong and negative market reaction. Stocks would get hammered with the world's primary provider of liquidity disappearing. If the Fed stops buying Treasury bonds, someone else will have to buy them, and I doubt that "someone else" will step into the breach without being offered notably higher yields on their bonds. These higher rates will cycle through the bond market and provide yet another headwind to corporate profits. In addition, the interest expense on our federal debt has been kept unnaturally low despite the massive increase in our debt due to the Treasury issuing more short-term debt (which carries lower interest rates than longer-term debt) as well as the outright manipulation of interest rates by the Fed. When interest rates go up, interest expense will eventually follow for everyone, including the U.S. government.

So, for now the Fed is printing $85 billion out of thin air each month to buy mortgage-backed securities and Treasury bonds. The voting membership will remain quite dovish in 2013. Importantly, the unintended consequences of trillions in monetary stimulus will finally begin to come home to roost should the Fed try to stop and ultimately unwind its stimulus. They may try and stop asset purchases at some point, but I would expect the drop in the stock market, the rise in bond yields, and renewed concern about the economy to be more than enough to get the Fed to back down in short order and rev up the printing presses again.

As our legislators turn their attention to possible spending cuts and the debt limit, don't forget the key role that the Federal Reserve plays in all of this. With the Fed printing money out of thin air and buying government debt at manipulated low rates, there is no bond market check on Congress or the President. They are able to continue running huge deficits without paying genuine free market (higher) interest rates on their borrowings and without imposing higher taxes on the American people. The Fed isn't part of the answer. It's part of the problem.

<u>Precious Metals Update</u>

A client recently expressed some frustration about our gold-mining stocks and suggested that a change in strategy may be warranted. I understand the frustration with these names. I personally have a very large exposure to the precious metals mining firms, so I'm acutely aware of their performance. We have had a couple big winners in the space, but the group as a whole is trading at the same level as in 2007. The price of gold has doubled over that period. I suppose it's a bit of a Rohrshach test with some seeing the miners as hopeless losers while others just see them as even more undervalued and attractive than they were five years ago. I'm squarely in the latter camp.

Over the years, I've tried to be very clear about what we should all expect with the gold and silver miners. No one should be surprised by their performance so far. To review:

1. We should expect <u>a lot of volatility</u>. These names can move 30% up or down in no time at all.

2. During the last great bull market in the 1970's through 1980, the gold miners didn't really shine until very late in the cycle. History doesn't have to repeat itself, but this cycle looks very similar so far. <u>Don't be surprised if these names don't take off for some time still, potentially years</u>.

3. We will see <u>tremendous variability in returns from individual mining equities</u>, especially in this current period during which the price of gold and silver are fairly flat. Should a bubble develop, almost every mining firm will rise significantly, but until then, performance will vary greatly based on company news and results.

4. These names <u>require great patience</u>.

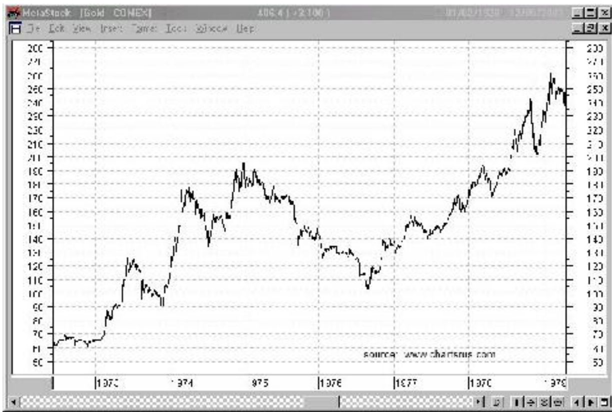
5. Ultimately, I expect the mining stocks to generate bigger returns than gold or silver. I expect silver to outperform gold, small junior miners to outperform the larger miners, and the miners overall to outperform the metals.

I've been warning that these names will be volatile and may take a long time to pay off for a very good reason. These names are volatile and may take a long time to pay off! Of course, I have no control over the timing of when gold and silver break out to new highs. All I can do is closely monitor the thesis for why we own these names. The thesis has shifted since 2002, but the backdrop remains very bullish for both gold and silver.

- All of the major central banks are actively printing money to try and devalue their currencies and support their banks and economies. Trillions of dollars, euros, Swiss francs, and yen have been created with absolutely nothing backing them except confidence in the central banks and governments. Gold can not be printed. More investors are waking up to this reality.
- We are seeing large and steady buying of gold by many central banks around the world, with Brazil a notable acquirer of late. This is in stark contrast to the period prior to the crisis during which central banks were large sellers. China, in particular, has been a voracious and steady buyer of gold. They want the yuan to eventually be a global reserve currency, and this won't happen if it's backed by U.S. Treasury securities, as it is now. I expect to see significant Chinese buying of gold for many years.

- The advent of exchange-traded funds (ETFs) has allowed individual investors and institutions ready access to gold and silver.

- The era of easily finding new gold reserves is gone. It is becoming increasingly more challenging and more expensive to find and develop a new mine. This helps support the price of gold.
- Some of the smartest investors in the world have come around to realize the value of gold in the current climate, including Jeff Gundlach, Bill Gross, Marc Faber, George Soros, John Paulson, Jim Rogers, and Kyle Bass. We're keeping good company.



Gold has been in a long period of consolidation. The price hasn't made any net progress since the summer of 2011. Such long consolidations may be frustrating, especially when other assets are rising, but they are a healthy part of a major bull market. As much as we would all like to make 20% or more every year in a bull market, that just isn't how they unfold. In the middle of the last great gold bull market in the 1970s, gold fell nearly every month for two years between 1975 and 1977. The miners fared even worse. Despite that, big gains were still to come between 1977 and 1980.

There are plenty of catalysts to drive the price of gold to new highs at some point. 2013 may turn out to be a wonderful year for the precious metals and miners, or it could present 12 more months of consolidation. Both are plausible. Nevertheless, the thesis for owning these positions is firmly intact, so we will wait patiently.

Although the supply and demand dynamics are both positive for gold and silver, a real bubble phase does not depend on this. Should a bubble develop it will simply come about because owners of the metals refuse to sell at anything other than a much higher price. If policymakers continue on their path of fiat currency printing and dilution, then it stands to reason that confidence in paper money will erode, and increasingly more investors and institutions will turn to unprintable gold as the ultimate wealth preserver.

Speaking of policymakers, the tailwinds supporting gold aren't just coming from the Fed. I've often warned that Japan would soon come into focus, and that's now happening. Shinzo Abe was recently elected Japan's latest Prime Minister. He held the post in 2007 but was forced to resign because, according to Japan Probe, he suffered from "crippling diarrhea that forced him to go to the toilet 30 times a day." I respect Abe for being the only politician that I'm aware of who has publicly admitted to being full of crap. Still, I don't see him as Japan's salvation. He is Japan's sixth Prime Minister since 2007. The country is the poster child for failed Keynesian economics, but Abe's "solution" is to go on yet another massive spending spree while also threatening the independence of the Bank of Japan, Japan's central bank. Abe has made it clear that he wants a cheaper yen and that he expects the Bank of Japan to play ball and monetize ever more financial assets, including Japanese sovereign debt.

Japan has the largest national debt relative to the size of its economy of any country in the world. They have borrowed hundreds of trillions of yen to "stimulate" their economy over the years, and all they have to show for it is a still weak economy now saddled with unpayable debt. Their solution? More of the same. This is sheer madness. This, my friends, is a prime example of why we own gold. It is a hedge against monetary and fiscal incompetence.

I'll wrap up this quarter's discussion of precious metals with a picture of future heartthrob Datta Phuge, a money lender in India. He was quoted in the Daily Mail as saying, "I know I am not the best looking man in the world but surely no woman could fail to be dazzled by this shirt?" The shirt, which he is sporting, is made entirely of gold and cost $25,000. It touches my heart to see the pursuit of true love alive and thriving around the world. I will soon be commissioning a smoking jacket make of cubic zirconias. Ladies beware.

Performance

U.S. equity and fixed income markets took a breather in the fourth quarter along with commodities. The best performers were international stocks. Europe benefited from a relief rally after Greece was given its umpteenth bailout. With nothing of substance being addressed, we should expect more European turmoil to surface at some point. China had a nice bounce after hitting levels last seen during the crisis, and the emerging market space also saw an inflow of capital. With liquidity (money) being pumped into global markets by central banks around the world, we should expect to see some pretty good volatility across asset classes as the flood of money shifts between countries and markets.

Index/Market	4Q12	Y-T-D
S&P 500	-1.01%	13.41%
DJIA	-2.48%	7.26%
Nasdaq	-3.10%	15.91%
Vanguard Total Stock Market (VTI)	-0.50%	13.97%
Vanguard International Stock Index (VGTSX)	5.27%	14.70%
Europe - Euro STOXX 50 Price EUR	7.40%	13.79%
China - Shanghai SE A Shares	8.76%	3.12%
India - BSE India Sensex 30 Index	3.54%	25.70%
Emerging Markets (VWO)	6.66%	16.54%
iShares Aggregate Bond (AGG)	-1.22%	0.75%
iShares 20+ Yr Treasury Bond ETF (TLT)	-2.45%	-0.06%
Dow Jones Commodity Index (DJP)	-6.47%	-2.11%
Gold (SPDR Gold Trust - GLD)	-5.81%	6.60%
Silver (iShares Silver Trust - SLV)	-12.28%	9.02%
Gold Miners (HUI Gold BUGS Index)	-13.54%	-10.93%
Oil (Cushing WTI spot)	-0.39%	-7.08%
U.S. Dollar (UUP)	-0.50%	-2.94%

Aspera Performance

In the third quarter, gold was up 11%, silver was up 25%, and the precious metals mining stocks were up 20%. Last quarter, I wrote, “Gold, silver, and the miners have had a big move up in a short period of time. They’re still very attractive longer-term, but big moves often attract some profit taking. At some point, there is a good chance that this space takes off and doesn’t look back, but this probably isn’t that time. Do not be surprised if these names pause or pull back a bit before the next move higher.”

Well, you can see from the table above that my warning was warranted. The metals and miners outperformed virtually every asset class in the third quarter and followed that up by underperforming most asset classes in the fourth. This was no surprise, but it of course impacted our returns last quarter. Gold, silver, and the miners remain at very attractive levels, and they remain my preferred investment.

Trading Activity – Closed or Reduced Positions

We were a bit more active in the fourth quarter when it came to trading. We cleaned out some detritus, captured some losses for tax purposes, and reduced risk incrementally.

As always, the fourth quarter brought with it the opportunity for some tax management in taxable accounts. At the beginning of the fourth quarter, it looked like we may be in store for higher dividend and capital gains tax rates in 2013, and I wrote that I anticipated selling some of our winners in taxable accounts in order to lock in lower 2012 capital gains tax rates. As the quarter progressed, I became more convinced that an agreement would be reached sparing most folks from higher tax rates, so instead of selling winners, I harvested some losses to be used in the future. With the January 1 tax deal, this turned out to be a good strategy.

SLV January 2013 Call Option

With the option set to expire relatively soon, I chose to close this position out. We rolled forward to a 2015 contract in a few accounts and will likely add this to more accounts soon.

Nordic American Tanker (NAT)

I don't guarantee much, but I do guarantee that we will have losers. It's hard to argue that NAT doesn't belong in the loser camp. The company owns large ships that transport oil around the world. If we're going to own a company in this space, NAT is a very good candidate thanks to its relatively strong balance sheet and consistent (so far) dividend. But, we never had to have exposure to this space. There has been a glut of tanker ships since the downturn in 2008, and this oversupply of vessels has kept day rates (the amount the company can charge to rent its ships each day) at depressed levels. I was well aware of this when we bought the stock, but I expected some rationality to gradually reduce the supply of ships and help bring the market back into balance. We have seen some scrapping, but we've also seen the Chinese continue to ignore market dynamics and build more tankers. My hope that rationality would soon return to the market has dimmed considerably, so we took our lump and moved on.

Miscellaneous Tax Loss Selling

Various positions were sold in taxable accounts to capture losses for tax purposes. These varied by client.

Petroleo Brasileiro Petrobras SA ADR (PBR)

PBR has been a disappointing company and stock. This company has had one of the most intriguing portfolios of property for oil drilling of any major oil company. Unfortunately, the Brazilian government has had a large and increasing involvement in the management of the company, and politicians rarely make effective allocators of capital. I remain very constructive on oil long-term, but we'll focus our oil exposure on companies that have less political exposure.

Trading Activity – New or Increased Positions

Apple Inc. (AAPL)

I have to admit to being surprised that I didn't receive one single smarmy email about not having bought Apple sooner. I had a wide assortment of wise cracking retorts ready to level at any would-be taunter but will have to save them for another stock on another day.

Of course, I've been well aware of Apple's relentless climb. Admittedly, I grossly underestimated the appeal that the iPad would have. With everyone (yes, except me still) already having a smartphone and a laptop, I apparently didn't have quite enough imagination to understand that people would still be willing to drop hundreds of dollars more on a glorified coaster. Either that, or I simply underestimated Steve Job's ability to convince consumers that their lives would be incomplete without an iPad.

Still, I didn't underestimate Apple's brand loyalty or innovation. The stock may not have been priced attractively enough for me given my growth, competition, and margin concerns, but the reality of Apple's product strength kept me from making the mistake of buying Research in Motion (RIMM) as its stock became ever cheaper (a classic value trap). It also kept me on the sidelines when it came to Nokia much longer than I otherwise would have been.

At $700 per share, I certainly wasn't interested in Apple stock. After falling 20% from those levels, however, the value proposition shifted. The growth and margin concerns that I've had for quite a while were finally being discussed in the investment community, helping to deflate the Apple myth and excess hopium in the stock. In addition, the company is paying a dividend and is a little less likely to do something stupid with its cash. Most importantly, the stock is cheap, and the company has a bullet-proof balance sheet. I'm comfortable hiding out in the name for now, and I may increase our modest position sub-$500, but I don't currently expect this to be a long-term holding.

Entrée Gold, Inc. (EGI)

We added to EGI early in the quarter in select accounts. This is a speculative name, and as a result, it's a small position for us. Entrée's primary asset is its interest in a large mine in Mongolia. The mine is not far from production and has large international backers, but the political climate in Mongolia has shifted. What had been a mining-friendly jurisdiction has recently taken on more nationalistic tones. The new government wants to renegotiate royalty rates and the mining consortium has refused. We'll see how this unfolds and won't be adding further to the name barring a positive resolution with the government.

CA, Inc. (CA)

We added a modest position in CA during the quarter. The company has a market value of $10 billion and is a large independent enterprise information technology management software and solutions company. This is a stock, but you really need to think of this as a bond position. The company pays a 4.5% dividend yield and has committed to a sensible program of reinvestment and returning capital to shareholders. This is not a homerun. The stock is cheap, and there is a new CEO coming on board, but we own this primarily for the steady yield that it should provide.

J.C. Penney Company, Inc. (JCP)

Ah, J.C. Penney. This is a classic contrarian situation. This is one of the most unloved stocks around these days. The company is in the midst of a huge turnaround attempt and has been posting some horrible same-store sales numbers and earnings for a number of quarters while it tries to completely revamp its stores and sales methodology.

In late 2011, JCP hired Ron Johnson as CEO. Johnson is the former head of Apple's retail business. The plan is to completely remake J.C. Penney. The company had relied heavily on coupons and sales in the past and is attempting to redesign its stores to a store-within-a-store model while dramatically reducing its dependency on couponing.

Turning around a retailer is never an easy task. Doing it in a world in which ever more people are choosing to shop online is even more complicated. Doing it while alienating your traditional customer takes the challenge to an entirely different level. There is a very real chance that the turnaround will fail. Despite that, the upside potential in the stock is large if the company succeeds or simply stops bleeding cash. In the worst case, the company could revert to its old model and also raise cash by monetizing its real estate assets. Given that the risk of failure does exist with JCP, we dipped our toe in the water with our non-conservative accounts.

Everbank Financial Group 6.75% Perpetual Preferred Stock (EVERpA)

We added a new position in this Everbank preferred issue to our moderate and conservative accounts. As you all know, I haven't been a fan of most banks for a long time. Bank accounting has made it nearly impossible to truly understand the quality of their balance sheets. One of the few banks that I have liked is Everbank. I've used Everbank as my own personal bank for many years and have been impressed with their service and their business model. The bank didn't make bad housing loans during the housing bubble and came through the latest crisis in good shape.

Preferred stock is a hybrid between a stock and a bond. In case of bankruptcy, it's higher in the capital structure than common stock but lower than a bond. It pays a nice yield – in our case, almost 7%. Unlike common stock dividends, this preferred dividend is fixed and won't be raised in the future. Before the company can pay its common dividend, it has to pay our preferred dividend. Unlike common shares, preferred shares don't come with voting rights. Like a bond, the price of this preferred will vary.

This particular preferred issue is perpetual, meaning the company doesn't have to redeem it. The company does, however, have the option of calling the issue (redeeming it) after January 2018. If Everbank's balance sheet or cash flow weaken or if interest rates move higher, you should expect to see the price of this security fall. As you know, I am concerned about interest rates eventually moving higher. This is a key reason we have limited our exposure to preferred stock, despite some tempting yields. This is one of the few preferred issues that has caught my eye.

iPath Coffee ETN (JO)

We added exposure to coffee at the end of the quarter in all but our conservative accounts. JO is an exchange-traded note which tracks the price of coffee, and coffee has been in free-fall since early 2011. It was the worst performing commodity in the Standard & Poor's index of 24 raw materials in 2012 – fertile ground for a contrarian investor. A number of factors have driven coffee prices lower, including healthy recent harvests, the economic slowdown in Europe, and a switch from more expensive Arabica beans to Robusta beans. In addition, speculators have built up a near-record short position in coffee futures (a bearish bet and a good contrarian indicator). Seems like a good time to dip a toe in the water. Of course, coffee prices could always fall further in the near-term, especially if upcoming harvests are robust. Agricultural commodities, however, tend to be mean-reverting. Low prices discourage new plantings which eventually lead to lower supply and higher prices.

The long-term supply/demand equation for coffee looks pretty good. It's similar to the outlook for oil. Near-term oversupply can certainly lead to lower prices, but a solid long-term supply/demand picture provides a nice tailwind and margin of safety. Notice, too, that coffee survived the 2008 crisis in fairly good shape. People may cut back on their Starbucks purchases a little bit during a recession, but coffee tends to be a "cheap" luxury that holds up well even in the worst of times. With more of the developing world "developing" a taste for coffee, I expect to exit this position at nicely higher more-caffeinated levels at some point in the next 2-5 years. Should prices keep falling back toward 2006 levels, you should expect to see another toe dipped.

Portfolio Positioning and Outlook

What will 2013 have in store for us? I wish I knew. We've been in uncharted territory for a few years, so making short-term predictions is foolhardy at best. That hasn't stopped all of the strategists and "experts" from issuing their 2013 forecasts. I spend absolutely zero time reading these as they tend to represent nothing but biased guesses reinforced by selective data mining.

From my vantage point, we remain in the eye of the hurricane, but no one knows just how wide the eye is. The massive borrowing and central bank stimulus of recent years has certainly forestalled the coming crisis, and it may continue to do so for some time yet. Nevertheless, I have no doubt that there will be payback to come, and it will be severe. The extraordinary measures that have been deployed since 2008 are simply breathtaking. Yet, what have they accomplished? We're essentially muddling along in the most anemic recovery any of us have ever lived through. At the same time, debt continues to build and the value of fiat money continues to be eroded through its multiplication. If the best that our policymakers can produce with trillions in stimulus is the worst recovery in memory, what exactly are they going to do when the next recession and crisis hit?

Jeffrey Gundlach is recognized as one of the best bond managers in the U.S. His views echo ours. At a recent presentation to investors, Gundlach explained the three phases of the current crisis. The first consisted of a 27-year period ending in 2008 which was marked by growing personal, corporate, and sovereign debt. We've since been in phase two, as governments and central banks have spent trillions to try and generate growth. The third phase, which Gundlach expects to come after 2013, will be a period of crisis marked by corporate and sovereign defaults. Central banks may forestall these defaults by printing even more money, with future inflationary pressures likely resulting.

Bill Gross, another leading bond market expert, put it well in his latest missive when he wrote, "The future price tag of printing six trillion dollars' worth of checks comes in the form of inflation and devaluation of currencies either relative to each other, or to commodities in less limitless supply such as oil or gold." I have no argument with Jeff or Bill. They both see the value in hard assets. Jeff has also recently been buying gold-mining companies because he views them as bargains. It's nice to have some smart company.

We remain generally biased toward wealth preservation. Valuation, debt levels, and building structural imbalances simply don't warrant an aggressive stance. Should equity and bond markets continue to rally, we will likely lag behind. This may prove frustrating, but I refuse to gamble with our money. There are plenty of other advisers who would be more than willing to do that for you if that's what you want. Rising financial markets have the tendency to impart undeserved confidence in the minds of investors that "everything is fine". Everything is not fine. I expect the next crisis which we're building toward to wipe out the recent gains of many stock and bond markets. Few will see it coming, but most will look back later and see that it was inevitable.

Despite my concerns, we do continue to own many securities. So long as the thesis for owning gold and silver remains solid, we will continue to have significant exposure to that space. They remain the most attractive assets in my view. We also have a number of nice yield positions, particularly in more conservative accounts. Our bias will continue to be toward exposure to real assets versus financial assets, and regardless of my macro concerns, we will add special situation securities when opportunities arise, as we did last quarter. Ideally, these names won't be strongly correlated with the market.

As we close out another year, I'd like to thank all of you for the trust you've placed in me. I'm lucky to work with people I genuinely like, enjoy, and respect. I'd have it no other way. Whatever 2013 brings, know that I continue to spend an unseemly amount of time and energy on our portfolios. I think I took all of 4 days completely off of work last year, and one of those was to run a 24-hour race. If I had a smartphone that day, I probably would have done some work out on the trail.

Time to wrap this up. I have a cubic zirconia smoking jacket to design.

Have a great quarter!

Best,

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