



## QUARTERLY INVESTMENT REPORT June 30, 2009

Dear Investor:

Have you ever climbed or hiked up a mountain? Anyone who has will attest to the fact that it requires both stamina and endurance. We have all climbed mountains figuratively, both large and small. Perhaps clichéd, but those peaks are analogous to the stock market. The mountain path has many switchbacks that seem to meander nowhere; they even often lead down the mountain for a stretch before connecting back to the ascent.

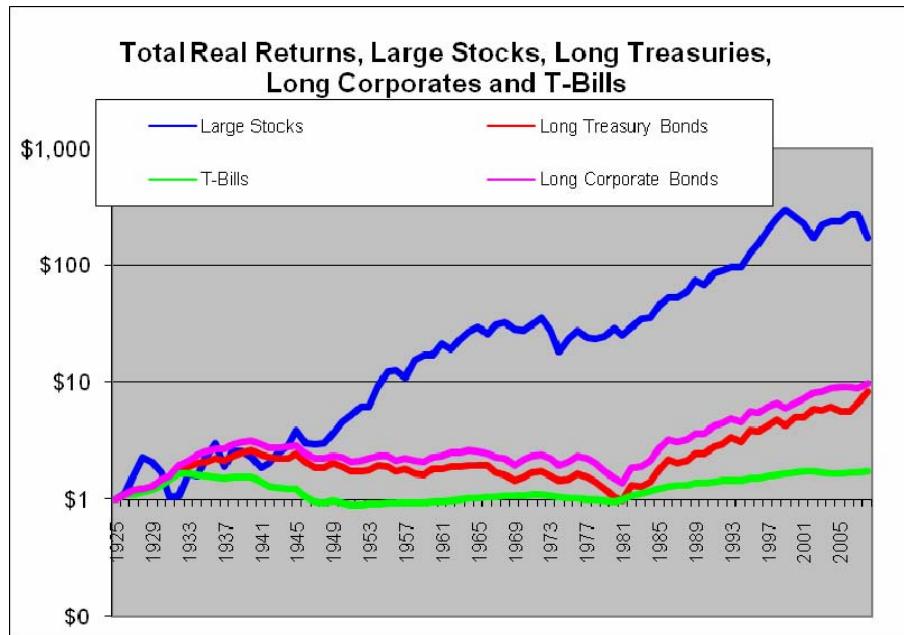
### **Stock Volatility is Normal**

Investors have experienced harrowing price volatility over the last twenty-one months, since October 2007. Volatility is not unusual for stocks, it was similarly wild in the early 1930's, mid 1970's, and the entire last eight years. We have also had quite a ride this year so far in 2009. It is hard to believe we have closed out the 2<sup>nd</sup> quarter with the S&P 500 up 16%, making it the best quarter performance since December 1998! While an encouraging indicator, we should keep our excitement in check since the 2009 year to date market is up only 3%.

The chart at the top of the next page is taken from Ibbotson Associates classic yearbook called "Stocks, Bonds, Bills and Inflation". It shows the inflation adjusted annual performance for large capitalized stocks, treasury bonds and treasury bills (treasury bills are a proxy for cash) from 1926 through 2008.

The chart illustrates that stocks have solidly out-performed bonds over the long-term. If we were to break down the long-term chart into rolling 20 year or 30 year periods we would see that stocks always beat out bonds. When we look at 10 year rolling periods stocks occasionally lose out to bonds, but overall, stocks are the winner.

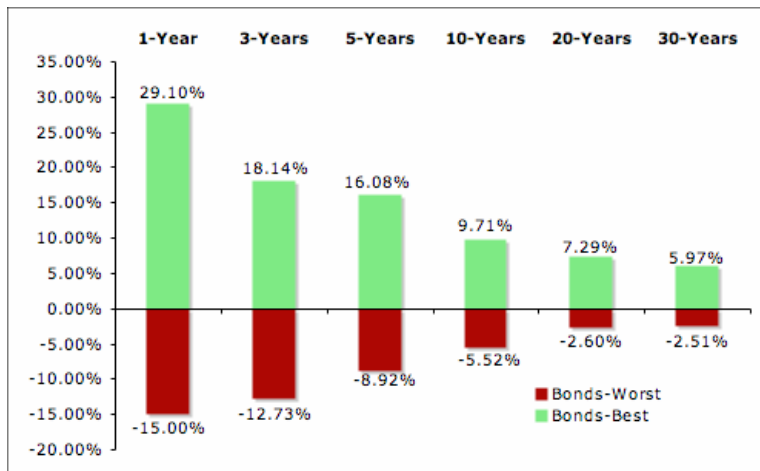
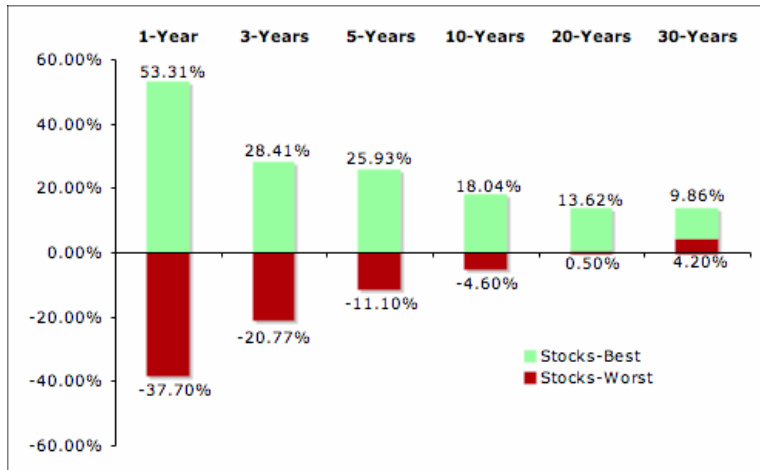
## ANNUAL INVESTMENT RETURNS SINCE 1925



Investment professionals have consistently preached the wisdom of investing in stocks despite the potential for loss in any one year. In recent months, as a result of the 38% loss in stocks in 2008 coupled with the 27% gain in treasury bonds in 2008, and the fierce volatility in 2009, there are those who now bang the drum for investors to permanently reduce stock allocations. They argue that stocks have lost their luster because of the harm done to corporate earnings from the financial crises and individuals' aversion to investment risk. Also, many investors worry that there is a serious threat of hyper-inflation due to the recent billions spent on stimulus, the upcoming billions that may be spent on reform initiatives, the alarming budget deficit approaching \$1 trillion (total public debt is more than \$11 trillion), and the unprecedented growth of Money Supply at the Federal Reserve.

At Ascend Capital Management we do not waver from managing balanced portfolios between both high quality stocks and bonds. Investors with at least a 10 year investment time horizon should have a healthy portion of holdings invested in stocks. Even seniors in their 60's, 70's, and 80's should own stocks.

## Range of Annual Returns for Different Holding Periods for Stocks and Bonds (After Inflation, 1928-2008)



Data from St. Louis Federal Reserve

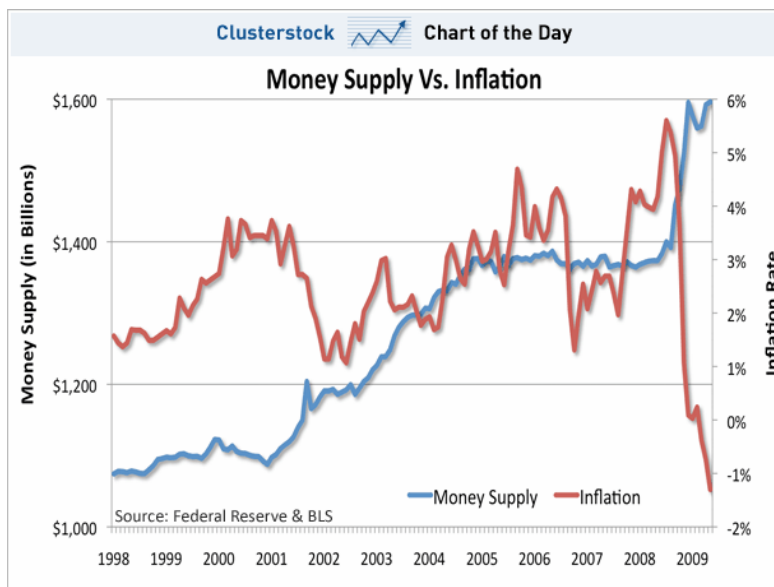
In the charts to the left we can see that bonds are also volatile. In fact, if we were invested in stocks and bonds for at least 10 years, the average annual decline in stocks of 4.6% is similar to the average annual decline in bonds of 5.5%. But the average annual increase of 18.0% from stocks is much higher than the 9.7% returned from bonds. It gets even better when our holding period is 20 years or more. **It is actually riskier to our wealth building goal to have an over allocation in bonds.**

If the charts above aren't convincing enough, think about the differences between stocks and bonds logically. A bond owner lends money to a company so the business can invest in a project. Bond investors are lenders. A stock owner invests in the company as an owner. The company isn't going to pay an interest rate on the loan at a rate more than they can earn on the project. The business manager borrows with the expectation of earning more on the project (perhaps 8% - 10%) than the cost of borrowing (perhaps 4% - 6%). As an investor who would you rather be? An owner or a lender?

## The Future Will Look Different From the Past

No one knows what the next 10 years will look like but there is a high probability that bonds will not out-perform stocks. Not only are stock owners rewarded better than bond lenders, but interest rates are currently so low that they are likely to rise over time. A rise in rates will cause bond prices to fall. Also, based on current valuations, stock prices are attractive. The average price to earnings (PE) ratio for the S&P 500 is currently 15 times. Over the last 30 years our PE has ranged between 7 times (1982) and 44 times (2000). Among 20 major countries globally, PE's range from a low of 6 times (Russia) to a high of 60 times (Taiwan). This makes our stock valuations relatively appealing to both U.S. and foreign investors.

In recent months many people have asked me about gold as a hedge against inflation as there are real concerns about all that money sloshing around in the system. First of all, the economy is too weak right now for inflation to become a problem. Consumers are saving, not spending, and price increases are practically non-existent right now. Down the road, as economic demand firms up I don't expect the Fed to allow inflation to get out of hand. I do expect moderate inflation, though, a few years from now and, at Ascend Capital Management, we protect portfolios by holding relatively short-term bonds and by investing in Treasury Inflation Protected bonds (TIPs).



**Despite the increase in Money Supply, inflation is not a problem in the near term.**

## What about Gold as an Inflation Hedge?

Gold has had a great run over the last ten years, handily outperforming stocks. However, over longer holding periods gold has lagged stocks. It tends to move based on expectations for inflation and those expectations are already built into the current price of gold and gold stocks. A strong whiff of deflation or a sense that gold is at a bubble valuation could very quickly punish gold prices.

## Careful! Building Wealth is More Than Blindly Balancing Between Stocks and Bonds!

Most people should be diversified between stocks and bonds, but the best allocations depend on an individuals' unique situation. How old are you? What is your probable life expectancy? What other assets do you have? Are they taxable or tax-favored?

Within each asset category there are both stable and volatile securities. In fact there are many times more volatile securities in the stock and bond markets than there are stable ones. It takes a great deal of experience and work to ferret out the strong companies from the weak ones.

At Ascend Capital Management we begin with screens that weed out companies based on capitalization, debt, return on investment, and recent years of revenue and earnings growth. The next steps involve an in-depth analysis of financial statements and management goals and operations. We review other companies in the same industries to understand who the leaders are and why.

We often tell people that if they aren't willing to or capable of analyzing a company for investment, that it is best to hire a professional. It's not just the quality of a company that is critical, but also the valuation of its stock. Warren Buffett-isms can get old but I never tire of one of his gems: He would rather buy a good company for a cheap price than a great company for an expensive price.

Like that mountain peak, the path to building wealth is circuitous. It requires expertise and patience to get to the top.

Have a very happy July 4<sup>th</sup> holiday!

Sincerely,



Ellen P. Le, CFA  
President



Remember...  
ignore the noise  
of the herd!