



Finance After Auschwitz

By Michael Lewitt, Editor, The HCM Market Letter

October 20, 2009

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This essay is excerpted from the most recent version of the HCM Market Letter. To subscribe directly to this publication, please go [here](#).



“The premier demand upon all education is that Auschwitz not happen again. Its priority before any other requirement is such that I believe I need not and should not justify it. I cannot understand why it has been given so little concern until now. To justify it would be monstrous in the face of the monstrosity that took place. Yet the fact that one is so barely conscious of this demand and the questions that it raises shows that the monstrosity has not penetrated people’s minds deeply, itself a symptom of the continuing potential for its recurrence as far as peoples’ conscious and unconscious is concerned. Every debate about the ideals of education is trivial and inconsequential compared to this single ideal: never again Auschwitz. It was the barbarism all education strives against.”

Theodor Adorno, *Education After Auschwitz* (1969)

It may seem alarmist to some readers to compare the obligation to prevent genocide from reoccurring to the obligation to maintain stable and moral financial markets. In fact, other than being belated, the connection is absolutely necessary. The stakes today are that high. The conditions that gave rise to the type of barbarism that led to genocide in Germany 70 years ago are no less present in our world today. As Adorno writes, “[a]mong the insights of Freud that truly extend even into culture and sociology, one of the most profound seems to be that civilization itself produces anti-civilization and increasingly enforces it.” Thirty years after Adorno’s admonition, insufficient attention is being paid to the fact that without functioning financial markets that are capable of raising capital for productive uses and creating opportunity for the disenfranchised, the world is far more likely to spin into anarchy. The grievances that led to Germany’s vicious rise to power in the 1930s are echoed in similar inequalities



around the world today. Having exported economic disaster to all corners of the world, the dominant Western economic powers need to reorder their priorities as they heal their economies in order to create a more equitable and stable global order.

As the tools of finance become more sophisticated, the obligation to regulate them wisely increases exponentially. In Modernity and the Holocaust (1991), the sociologist Zygmunt Bauman argued that two of modernity's signal achievements made the holocaust possible - technology and bureaucracy. In fact, he argues, the genocide of the Jews (and murder of millions of others) was carried out in a manner that was completely consistent with the norms of how business was conducted at the time. In other words, Auschwitz was an example of modernity cannibalizing itself. Why can't the same be said about modern finance and the succession of increasingly destabilizing financial crises that have consumed the financial markets over the past two decades? Beginning with portfolio insurance, which contributed to the stock market crash of 1987, and continuing through credit default swaps, which swept away some of the world's largest financial institutions in 2008, financial technology became the tool that almost destroyed the very system it was designed to protect from risk. What could be a better example of Adorno's "civilization creating anti-civilization"? And if it is indeed the case that our best tools are also the ones that are most capable of destroying us, mustn't we educate ourselves to prevent that from happening? As the perpetrators of the crisis try to sneak away from the scenes of their crimes unseen, it is incumbent upon the rest of us to insure that the intellectual and moral lapses that caused so much damage are exposed for what they are. Only after this flawed thinking is exposed can be disposed of.

The Iranian threat

It is no accident that the most imminent danger now comes not from the least advanced but from the most modern society in the Middle East, Iran. Iran's attempt to gain nuclear weapons capabilities should not surprise anybody who is a student of ancient or modern history. Iran has a highly Westernized populace governed by a retrograde group of clerics and a Holocaust-denying President whose legitimacy is open to question. Mr. Ahmadinejad's hatred was on full display last week at the United Nations, where for some reason he was again allowed to speak as though his country should be numbered among the community of nations when it refused to conform to the laws that guide those nations. Moreover, Mr. Ahmadinejad's support within his own country comes primarily from the Revolutionary Guards, a particularly unsavory group whose economic and political power continues to grow at the expense of the rest of the polity. In its latest coup – this time, fortunately, non-violent - the Revolutionary Guards were able to purchase just over 50 percent of Iran's Telecommunications Company in a \$7.8 billion deal (we can only guess where they obtained the money). Tyrants are particularly eager to control the communications systems of their countries, and it was hardly an accident that text messaging was cut off on election day in Iran and the cell phone network was disconnected during the unrest that followed Ahmadinejad's phony



victory. The Revolutionary Guards' shopping spree will undoubtedly continue with the purchase of more key strategic assets.

The events unfolding inside Iran are a recipe for instability both inside that country and in the surrounding Middle East. Western leaders are faced with a host of bad choices, but none of those choices includes inaction. Iran, which is Persian in origin but Arab in political alignment, is thumbing its nose at the West, and part of its goal is to provoke a reaction that will further divide the Arab world from the Western powers. Saddam Hussein thumbed his nose at the West but was not building weapons of mass destruction; some of us believe the Bush Administration did the right thing in not leaving things to chance and *HCM* for one shed no tears when he met the gibbet. Iran is a far more complex challenge, but anything that allows Iran to build a nuclear capability will turn out to be a profound mistake for all of mankind. Iran professes that it needs nuclear energy, but only a fool would buy that argument - the country is sitting on enough oil to last it for eternity. There is only one reason for it to build a nuclear capability, and just in case the world isn't paying attention, its President has made no secret of what he plans to do with it: destroy Israel. Acting sooner rather than later is the only choice that makes sense, beginning with strict economic sanctions if meaningful inspections of the sites in question are not permitted immediately. The only way to prevent another Auschwitz is to take the difficult steps now. It will only become tougher later.

Is the stock market overvalued?

David Rosenberg, one of the smartest economists and strategists around, made a very compelling case recently that the stock market is dangerously overvalued. Our reaction to his essay in the September 23, 2009 issue of the *Financial Times* is that he is basically correct but for the moment it probably doesn't matter – the market is unlikely to sell off dramatically in the near term. We also agree with Mr. Rosenberg's argument that the credit markets are not overvalued and offer far more attractive investment opportunities than equities today.

Mr. Rosenberg argues that the S&P 500 is currently trading at its most expensive level in seven years – 26x operating profits and 180x reported profits. Those are indeed tech bubble-like levels. He also points out that the market is priced for 4 percent real economic growth in the coming year, which Mr. Rosenberg views as unlikely. We would point out that reported growth may appear less attractive than real growth if the deflationary dynamic continues to haunt the economy, as *HCM* expects. Nonetheless, sustainable 4 percent real growth is a tall order in view of the absence of non-governmental sources of growth.

The real question about equity market valuation will come down to corporate earnings, which have managed to surprise on the upside thus far in 2009. The third quarter should again provide reasonably good news on this account, although there will be a lot



of noise in the numbers for both the third and fourth quarters. Readers need not be reminded that economic activity came to a grinding halt around this time last year, causing third quarter 2008 numbers to weaken and fourth quarter 2008 numbers to fall off a cliff. As a result, 2009 comparisons with last year's numbers should be highly flattering. But investors should not be fooled. Companies continue to generate profits from cost cutting and balance sheet mending, not from revenue growth. The true test will come during the fourth quarter of 2009 and 2010, when companies will have an opportunity to operate in an economic environment that, at least on the surface, appears to have stabilized. It is not unreasonable to see companies lose revenues while the economy is experiencing and then recovering from a deep recession. By now, however, the economy has stabilized sufficiently to give us an idea of whether revenue growth is going to resume or not. This is particularly true with respect to the ability of companies to obtain the financing needed to operate their day-to-day businesses. If revenue growth is going to remain below trend, as observers like Mr. Rosenberg expect, then the equity market is certainly going to be in for a difficult time.

Other investors with similar market views have been left behind by the rally. In a September 28 article, *The Wall Street Journal* highlighted several extremely well-regarded investors that have suffered such a fate this year ("Pessimism Exacts a Price on the Skeptics," p. C1). Firms such as Peter Thiel's Clarium Capital (-12 percent thus far in 2009), John Horseman's Horseman Capital (-20 percent), and Jim Simons' Renaissance Technologies (-12 percent, although we hear that the fund that manages Mr. Simons' and his partners' money is doing better) are suffering from the view articulated by Mr. Thiel that "[t]he recovery is not real. Deep structural problems haven't been solved and it's unclear how we will create jobs and get the economy growing again – that's long been my thesis and it still is." *HCM* considers Mr. Thiel among the most thoughtful investors on the scene today, and we take his views very seriously. In fact, we concur with his view that the deep structural problems in the economy have not been solved and if anything has been exacerbated by the measures taken by the government to prevent the economy from falling off a cliff. We do not, however, believe that such negative views will pay off anytime soon because of the return to health of the credit markets. As long as companies can obtain credit at a reasonable cost and on terms they can live with, the economy should continue to slog along and take the stock market along with it.

Readers will remember that *HCM* was among the few who predicted the crisis before it occurred. We were as negative as anybody. Late last year, *HCM* warned that the stock indices could drop even lower than they subsequently sunk in March 2009, and we were slow to believe in the rally early this year. We still generally concur with the bearish long-term view of the economy held by David Rosenberg, Peter Thiel and others. That said, we do not believe that the equity or credit markets are due for an imminent reversal (and the two markets are closely linked in today's interconnected, globalized world). The reason for our optimism is squarely based on our experience in and knowledge of the credit markets, which continue to show every sign of healing. While



the initial impetus for this recovery clearly came from government support, the private sector (with the notable exception of the banks¹) has stepped in to provide financing for many corporations needing loan extensions or refinancing. There are reasons to be concerned that non-bank financing may become harder to come by in the near future, as we explain below, but abominably low yields and abundant liquidity suggest that reasonably healthy borrowers should be able to access capital for a prolonged period of time, something that was not the case beginning a year ago and lasting for six months thereafter. Moreover, low yields are compelling investors to search out investments that offer them what they view as reliable returns without undue risk. This accounts for the ability of corporations in decent financial health, and even some in not-so-decent health, to raise large amounts of capital in 2009 to refinance or extend their existing debt.

The flip side of such a low interest rate environment is that it may well sow the seeds for another credit bubble. The bubble that burst in 2007-2008 was created by the Federal Reserve keeping interest rates too low for too long, and by investors accepting too little return on their capital for too much risk. While the credit markets were clearly grossly undervalued at the depths of the crisis earlier this year, they have quickly moved to a point of fair valuation in many areas, particularly high quality corporate credit. The danger now is that corporate credit will again overshoot and offer investors too little return for the risks they are assuming. Investors need to retain one of the lessons that the crisis should have taught them: in leveraged companies, every layer of the capital structure is a type of debt because there is a risk of default associated with the issuer. Accordingly, even though this is too much to hope, it would be much better for the markets if investors would remain disciplined and insist on being properly compensated for the risks they are assuming when they invest in credit instruments.

The great dilemma the Federal Reserve is facing is when to raise interest rates again. *HCM* does not believe that the central bank will raise rates to any significant degree before 2011 at the earliest based on its historical focus on inflation, of which there is virtually none in the U.S. economy today. Nonetheless, the proclivity of the Federal Reserve to keep rates too low for too long has been a major contributor to the series of bubbles that led to the Mother of All Bubbles that burst in 2008, and Chairman Bernanke is going to have to do a better job than his predecessor to avoid a continuation of the policies that served us so poorly in the past.

The death of securitization

On September 17, Standard & Poor's published revised methodologies and assumptions for rating Collateralized Debt Obligations (CDOs) backed by corporate debt (that's a long way of saying they screwed up everything before and think they are fixing it now). As a result, the ratings agency placed on negative CreditWatch approximately 4,790 public rated corporate CDO tranches with an approximate face

¹ For more on this, see Chart 1 on page 5.

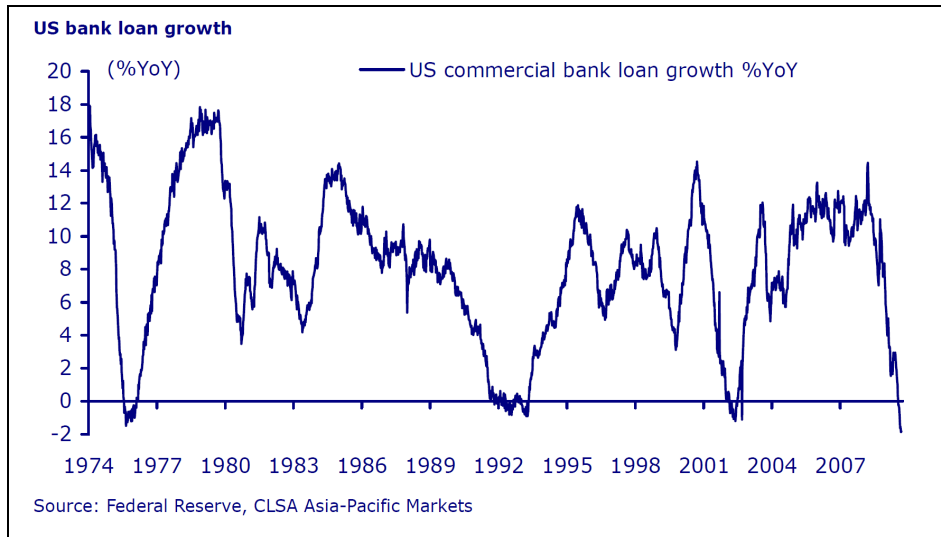


amount of \$578 billion. S&P projected that its new methodology would result in average downgrades of one ratings notch for super senior AAA notes and 2-3 notches for junior AAA through BB tranches. Among the key changes S&P made to its ratings assumptions were requirements that BBB tranches must be able to withstand the worst observed corporate default rates since 1981, and AAA notes must be able to survive Great Depression-equivalent macro event default scenarios. In other words, S&P finally acknowledged the Black Swans that were shitting all over it for years. S&P had already made similar moves with respect to its widely discredited ratings in the mortgage area. In the corporate loan area, however, there are important systemic implications to its belated and poorly thought-out actions.

With this announcement, S&P accomplished several things. First, the revisions constitute an admission that its prior ratings were based on profoundly flawed intellectual assumptions and ratings models. Unfortunately, they have replaced their original mistakes with equally serious ones. Second – and most important from a systemic standpoint – the revisions effectively hammer the final nails into the coffin of the securitization of corporate debt. Third, with these revisions S&P unilaterally changed the rules governing hundreds of billions of dollars of Collateralized Loan Obligations that were issued over the past few years. It did so without giving investors in these transactions any right of appeal, or any recourse to recover their potential losses. Investments were made based on earlier ratings which arguably constituted an implied promise by the ratings agencies to maintain the original set of assumptions underlying their ratings. By unilaterally changing these assumptions to account for the first time for Black Swans, S&P has broken its compact with the entire financial world that came to rely on its ratings. This *post hoc* approach reflects extremely poorly on the intellectual abilities of the credit rating agency.

Fifth, S&P is effectively raising the cost of capital for less than investment grade companies that are already suffering from a dearth of available capital sources. Moreover, it is doing so after credit conditions have improved. While the rating agency is a private sector entity, it has enjoyed the imprimatur of the Securities and Exchange Commission that requires so many areas of finance to rely on its ratings. Moves like this, which are dressed up in intellectual clothing but are little more than *ex post facto* attempts to correct its prior mistakes, have large systemic effects. The problem is that these systemic effects are being inflicted by an organization that has surrendered any claim to intellectual legitimacy by its prior errors. Moreover, it is compounding those errors by making changes to its ratings assumptions that fly in the face of current data that suggests that corporate credit conditions are improving, rendering its heightened default scenarios highly unlikely to occur and unsuitable for application to these structured credit products.

Chart 1: Where are the Banks?



Legislative proposals to rein in the problems caused by undue reliance on rating agencies are inadequate. The first thing that must be done is to increase intellectual competition among those who are granted the authority to rate credit. The existence of an oligopoly has created a situation in which Moody's Investors Service and Standard & Poor's engaged in a race to the bottom in their fight for market share. Standards of analysis must be raised in order to insure that the mistakes of the past will not be repeated. The ratings assumptions and models that created so much damage were based on a series of false assumptions. First, they assumed that that past behavior would serve as a reliable indicia of future behavior. In the mortgage area, this laid the basis for utilization of FICO scores to rate mortgage borrowers, overlooking the fact that these scores were based on historical contexts that no longer applied to current circumstances. It also served as the basis for flawed models used to rate Collateralized Bond Obligations in the late 1990s, which used outmoded default and recovery assumptions for corporate bonds that were useless in predicting corporate bond behavior during the 2001-2002 bond market collapse. Second, ratings agencies assumed that markets would behave rationally and that rational behavior on the part of individuals would lead to rational behavior on the part of large groups of individuals. Known as the "fallacy of composition," this overlooked the well-known observation that individuals often act irrationally and that even when they act rationally, taken as a whole the rational acts of large groups of individuals can lead to irrational behavior (i.e. it may be rational for one investor to sell, but when all investors sell it leads to irrational panics). The rating agencies, which were anointed by the SEC and others to be smarter than anybody else about these matters, turned out to be precisely the opposite and led the markets down the road to disaster. Some of us, but not enough of us, realized that credit rating agency opinions should be treated with a grain of salt.



The tragedy is that S&P's recent move suggests that they are being permitted to stick it to investors again. The rating agencies fail to understand that corporate loans are different from bonds or mortgages. Instead, they are applying the same standards they erroneously applied to Collateralized Mortgage Obligations and Collateralized Bond Obligations to Collateralized Loan Obligations. As a result, they are downgrading CLOs and limiting their ability to provide capital to less than investment grade companies in an already difficult financing environment. They are doing this without regard to the consequences of their actions, which is to render financing harder to come by for viable companies that need access to capital. Despite improved credit conditions, less-than-investment grade companies remain faced with the same situation that they have always faced, i.e., the rationing of credit. Banks long ago exited the lending business in favor of the originate-and-distribute model, and in the aftermath of the crisis have little desire to add assets to their balance sheets. As Chart 1 on the previous page illustrates so graphically, the banks are still in the process of exiting the lending business and nobody appears to be filling the gap. One of the last men standing to purchase less-than-investment grade securities in large volumes were CLOs, and an increasing number of these are being frozen out of the market by these downgrades just as market conditions are improving. This is directly contrary to the efforts the Obama Administration is making to encourage lending, and is another reason why credit agencies should be subject to far stricter regulation in view of the damage they have already done and continue to do.

Private equity

HCM is encouraged to see that private equity investors are finally organizing to protect their interests, although it is frankly disappointing that they have to protect themselves from the managers to whom they entrust tens of billions of dollars. After all, those managers are supposed to be acting in the best interests of their investors, not themselves. *HCM* realizes that such a statement sounds in view of how these managers behave toward their investors and lenders in the real world, but it needs to be said nonetheless. It appears, however, that institutional investors are finally beginning to insist that they be treated better than they have in the past.

A group of 220 investors with up to \$1 trillion invested in private equity have reportedly grouped together to demand that private equity funds adopt a framework of best practices and align their interests more squarely with those of their investors. The new group is called the Institutional Limited Partners Association. According to the *Financial Times* ("Buy-out groups face fight over fees," September 29, 2009, p. 18), many private equity firms are resisting these demands, particularly as they affect the fees that they charge their limited partners for everything short of going to the bathroom (that billing technique belongs to lawyers). As *HCM* has written before, private equity firms not only charge basic annual management fees in the 1.5 to 2.0 percent range (on both invested and committed capital), but also charge additional fees for everything else they do in managing their portfolio companies: buying them, selling them, financing them, taking



them public, etc. The most recent example of these fees was the disclosure in the prospectus for the initial public offering of Dollar General by Kohlberg Kravis & Roberts and Goldman Sachs of the fees that were paid to those sponsors when the \$7.3 billion buyout was completed in 2007 (this is one of the rare 2007 vintage deals that has worked out). Dollar General paid them \$75 million of “transaction fees” when the deal closed, another \$13 million in “monitoring” fees, and plans to pay them a further \$64 million if its planned offering goes ahead (for terminating their “monitoring” fees, which is absurd beyond description). What did the sponsors do to earn these fees in addition to the management fees they are charging their funds? From *HCM*'s standpoint, they did nothing other than what they were paid to do in the first place. How would investors feel if a hedge fund charged an additional fee each time it bought or sold a stock or bond? These fees are an offense to reason and the fact that investors have to argue with their private equity managers to eliminate them reflects very poorly on their managers. The fact that they agreed to pay them in the first place reflects poorly on them.

Large buyout firms are reportedly preparing to roll out their next round of large funds in the next year or two. Those large institutional investors who have tied up tens of billions of dollars in these funds would do themselves and their beneficiaries a huge amount of good if they would seriously examine the returns they have received from private equity on a risk-adjusted basis, which would involve adjusting these returns for liquidity (or lack thereof) and leverage. They would also do well to consider whether their private equity investments make sense for their beneficiaries and society as a whole in terms of whether they are promoting investment in the economy. Investing in buyout firms that merely flip companies among themselves, or load companies with debt without improving their operations or helping them create new products, is hardly conducive to improving the economy.

There is a movement afoot by a number of states, including our home state of Florida, to prevent public funds from investing in companies that directly or indirectly support terrorist states such as Iran and the Sudan. *HCM* would suggest that such socially responsible investing should be extended to direct capital away from speculative endeavors such as private equity and toward activities that contribute to the productive capacity of the economy. The more money that is poured into private equity, the less money that is available to finance other activities that do more than simply substitute debt for equity on the balance sheets of America's corporations. The love affair with private equity has not only produced disappointing returns, but it has had an incalculable (but enormous) opportunity cost on American society and its economy whose price will be born for generations to come.

Japan's setting sun

For years, *HCM* has written about Japan's inability to reform its financial system in the wake of its own bubble economy. This is not a topic we have touched on lately, largely due to the fact that events in Japan were subsumed by the global financial crisis and the



United States' own race to the economic bottom. Nonetheless, Japan remains a crucially important component of the global financial system, and some are warning that its economic outlook is growing ever bleaker.

Japan is the second largest holder of U.S. debt with \$720 billion on its books (only China, with \$800 billion, and the Federal Reserve, with almost \$5 trillion according to The Gartman Letter, is larger). The country's gross national debt is equivalent to 217 percent of its gross domestic product, compared with 81.2 percent for the U.S. (but don't worry, we are working hard to catch up!) and an average of 72.5 percent for the G-20 nations, according to the International Monetary Fund. The most troubling challenge facing the Japanese is their demographic future: over the next 40 years, its population is projected to fall by 20 percent while the number of working men and women is expected to drop by 41 percent. The country is facing a situation where an aging population will have an insufficient number of workers to support it.

The second most troubling challenge facing Japan is its sclerotic and corrupt political system. Last month, the Democratic Party of Japan (DPJ) defeated the deeply entrenched Liberal Democratic Party (LDP) with promises to dramatically reform the country. Readers should remember that the term "bridge to nowhere" originated in Japan's public works projects designed to feed work to the LDP's cronies while doing nothing to add to the productive capacity of the island nation's economy. Some observers are optimistic that the DPJ will bring much-needed reform to Japan, just as they were encouraged by the election of Prime Minister Koizumi a few years ago. Unfortunately, the LDP is so deeply entrenched in Japan's power structure that the best case scenario is that some modest change might occur at a snail's pace while the ineluctable demographic trends continue to march forward.

In a recent story in *Barron's*, several Japan experts expressed concern over Japan's ability to service its debt in the future. Goldman Sachs' Tokyo-based economist Tetsufumi Yamakawa warns that Japan's annual budget may hit 10 percent of GDP for the next three years if the DPJ's promised stimulus programs are passed (this sounds very familiar to those of us in the U.S.). Mr. Yamakawa is also concerned that the interest rates on Japan's public debt may soon become persistently higher than the country's nominal GDP growth, which would lead to permanently growing government debt. That may well occur, but GDP growth would have to be extremely low (which is certainly possible) since Japan's interest rates are unlikely to rise to any meaningful extent in the foreseeable future. In fact, the world can continue to expect a prolonged period of low interest rates as it attempts to heal from last year's crisis. Japan's benchmark government bond, the JGB, currently yields about 1.3 percent. *HCM* doesn't expect any dramatic rise in this yield, although some disagree.

There is only one thing we know for certain about Japan – things move very slowly. Japan is unlikely to give rise to any type of near-term crisis. Instead, the Japanese economy is far more likely to go out not with a bang but with a whimper.



Interestingly enough, the Japanese Yen is no longer the currency of choice for the global carry trade. That dubious honor has been assumed by the U.S. dollar. It is always tempting to draw comparisons between Japan and the U.S., but the differences are far greater than the similarities. From demographics to culture, the U.S. is a far different place than Japan and has demonstrated a far more aggressive approach to dealing with its financial crisis than Japan has taken with its slow motion meltdown. If anything, U.S. authorities have learned from Japan that aggressive action is necessary to prevent a prolonged slump. This has forestalled the immediate crisis but created long-term imbalances that will have to be addressed. In many respects, even in today's increasingly flat world (to borrow Thomas Friedman's lingo), Japan remains a special case. The lessons it offers for other are important, but they are limited. Nonetheless, what happens in Japan over the coming years will have an important impact on investors throughout the world and should be watched carefully.

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The HCM Market Letter
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