



At the Risk of Repeating Ourselves

By Michael Lewitt, Editor, The HCM Market Letter
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“I am still trying to make sense of the last decade of grotesque financial mistakes. One compass that helps is the training I received when I did a PhD in social anthropology, before I became a journalist some fifteen years ago. Back in the 1990s, when I first started working as a financial reporter, I used to keep rather quiet about my ‘strange’ academic background. At that time, it seemed that the only qualifications that commanded respect were degrees in orthodox economics or an MBA; the craft of social anthropology seemed far too ‘hippie’ (as one banker caustically observed) to have any bearing on the high-rolling, quantitative world of finance.

“These days, though, I realize that the finance world’s lack of interest in wider social matters cuts to the very heart of what has gone wrong. What social anthropology teaches its adherents is that nothing in society ever exists in a vacuum or in isolation. Holistic analysis that tries to link different parts of a social structure is crucial, be that in respect to wedding rituals or trading floors. Anthropology also instills a sense of skepticism about official rhetoric. In most societies, elites try to maintain their power not simply by garnering wealth, but also by dominating the mainstream ideologies, in terms of both what is said and what is *not* discussed. Social ‘silences’ serve to maintain power structures, in ways that participants often barely understand themselves let alone plan.

“That set of ideas might sound excessively abstract (or hippie). But they would seem to be sorely needed now. In recent years, regulators, bankers, politicians, investors and journalists have all failed to employ truly holistic thought – to our collective cost.”

Gillian Tett, *Fool’s Gold* (2009)



Gillian Tett's book about how the credit default swap market became the monster that swallowed not just Manhattan and London but the entire global economy is an instructive and entertaining read. Ms. Tett is one of the more astute financial journalists on the scene today, and *HCM* found the explanation of her holistic approach to interpreting the financial markets to be similar to our own. Both in writing this newsletter and in providing investment services for our clients, *HCM* has attempted to apply our background in literature, history, philosophy and law.

We are certain that our quantitative-minded competitors will find this admission appalling, but hopefully not as appalling as the massive losses they have incurred over the years by placing undue reliance on investment models that are flawed in conception and execution. *HCM* believes that one must be a close *reader* of financial markets, and reading is a skill best learned through a thorough grounding in the humanities. Science and math have their place in the investment world, but too much emphasis on these disciplines has too often led to disaster (i.e. Long Term Capital Management). Investing is far more art than science. *HCM* long ago concluded that investors would be better served by studying psychology than economics in trying to understand the markets, and the school of thought known as behavioral finance has undertaken to combine these two fields very effectively. As Ms. Tett's history of a good idea gone wild demonstrates, a familiarity with the irrational is far more valuable than quantitative and technical knowledge in evaluating the market landscape.

A Summer Calm, or Calm Before the Storm?

Investors can be grateful for the first calm summer in several years. The last two summers were particularly volatile and painful as the world came to terms with the fact that its so-called abundance was a mirage, so 2009's relative calm and recent rally are a welcome respite from difficult times. Living in market time can warp one's sense of reality, however, primarily by shortening one's time horizon to the point that one loses one's historic sense. One of my former professors, the Marxist literary and cultural critic Frederic Jameson, opened one of his most important books with the following words: "It is safest to grasp the concept of the postmodern as an attempt to think the present historically in an age that has forgotten how to think historically in the first place."¹ Written almost two decades ago, those words ring ever truer today as markets have succeeded in shortening our time horizons and de-historicizing our frames of reference. In many ways, the remnants of Americans' attention spans that television didn't wipe out have been eradicated by the advent of computerized trading and 24/7 news coverage of the financial markets. The ability to digest information and place it within any kind of meaningful context has been compromised by the constant stream of information that is overwhelming in its volume and underwhelming in its relevance. Nonsense has been elevated to the level of news, while news has been devalued to the level of nonsense.



Despite what the pundits would have you believe, nobody has the faintest idea whether the economy is going to experience sustainable growth once the government stops stimulating it. The Armageddon trade is clearly off the table, but the Return to Nirvana trade is nowhere on the horizon either. Second quarter earnings were impressively ahead of estimates, but like first quarter estimates were again based on cost cutting and balance sheet reparation, not revenue growth. In fact, revenues were sharply down in virtually every industry, suggesting that the economy is still shrinking. An economy can't shrink itself to prosperity, so sooner rather than later either revenue growth will appear or there will be more trouble ahead. The good news is that the pace of revenue declines appeared to slow somewhat in the second quarter, providing hope that the third quarter might show some actual growth.

The employment picture remains very weak, although there are dim signs that job reductions are beginning to slow now that casualties from the shutdowns of auto plants and dealers have been absorbed into the numbers. This by no means suggests that job growth is imminent. If there is a silver lining behind these numbers, it is that Corporate America has reduced its cost structure so significantly that profits should flow once revenues pick up. If corporations can maintain their spending discipline, the outlook for corporate profits in many sectors of the economy – at least those least affected by the consumers losing their jobs – should be quite positive.

We may also be reaching a trough in housing prices in many markets in the U.S., and any stability in this sector would be a necessary first step to recovery. But the signs of recovery are slight and are no cause for celebration. To the extent there is evidence of improvement, it appears that bargain hunters and first-time buyers are responsible for higher transaction volumes at the low-end of the market. According to the National Association of Realtors, first-time home buyers accounted for 29 percent of existing home transactions in June 2009 and distressed properties comprised 31 percent of existing home sales. But the American consumer is still going to be casting a pall over the economy for a prolonged period of time, aided and abetted by banks and other financial institutions that are continuing to make credit scarce despite government pressure to lend and their public pronouncements to the contrary. On the other hand, the commercial real estate market is not improving and is still deteriorating. The *Moody's/REAL Commercial Property Price Index* dropped by a sharp 7.6 percent month-over-month and 28.5 percent year-over-year in May, which is consistent with the anecdotal evidence *HCM* is hearing from friends in markets throughout the country.² It is going to be a long slog out of the economic hole we have dug for ourselves, so stock market investors should be wary of the siren song of irrational exuberance. We are not out of the woods yet, but the trees are starting to thin out a little bit.

For the moment, the authorities have succeeded in derailing a repeat of the Great Depression of the 1930s, but only by imposing a future cost on society that is impossible to calculate. Trillions of dollars have been spent or committed to massive job programs and to the social safety net, which is what the government is supposed to do



in times of crisis. Some of the money was spent wisely, much of it was not. Unfortunately, a great deal of the money spent at the federal level was sucked out of the system on the other end by state and local governments whose fiscal situations have continued to deteriorate throughout the past two years. But at least the hemorrhaging has stopped, even if the bandages are still leaking around the edges. Whether our children will be able to forgive us is something many of us may not be around to learn, but unless someone has invented free lunches while the world was teetering on the edge of the abyss, there are going to be some angry kids growing up to pay our bills in generations to come.

Wall Street is doing its best imitation of Rip Van Winkle and conducting itself as though time skipped from 2006 to today. TARP is an inconvenient memory for those firms that were fortunate enough to be able to repay the government, while those still in debt to the U.S. government are trying to talk their way out of compensation restrictions using the same tired arguments about needing to attract talent to be able to blow themselves up again. Wall Street is lobbying hard against meaningful derivatives regulation in the little time it has to spare between raising salaries and signing exorbitant new contracts to hire new traders who were somehow missing-in-action in 2008 when their alleged talents were really needed. We've all seen this movie before and it always ends badly, but it seems nobody can pull their eyes away from the screen. We can do better but we just don't seem to have what it takes to do better. Watching Wall Street trotting out the same old tired arguments about risk-taking in the wake of what occurred over the past couple of years is enough to make one want to haul out the torches and pitchforks.

The Credit Markets

The recovery in the corporate credit markets thus far in 2009 have been nothing short of incredible. *HCM* must admit to some surprise that these markets recovered so much ground so quickly, particularly the high yield bond market. Unsecured debt seemed to be a poor bet early in the year from a risk/reward standpoint. But with spreads that at one point exceeded 2000 basis points, investors with greater risk appetites than our own were prepared to take more risk than we were (or were stuck holding low-priced bonds and figured they had little to lose by holding on) and realized large gains on their lower quality holdings. With the corporate default rate currently hovering in the mid-teens, many borrowers are now defaulting or entering consensual restructurings that will likely produce disappointing recoveries for their unsecured debt holders. But the strong rally provided an opportunity for some holders to escape their worst losses and allowed the high yield market to boast some good short-term performance numbers that will likely suck in more victims to what remains a horrible asset class.

As we have written many times, investing in unsecured debt is a loser's game. This is particularly true with respect to investments in the unsecured debt of private equity portfolio companies, where the private equity firm keeps all of the upside and the unsecured lenders are apportioned most of the risk and virtually no upside. The fact that



this market rallied 20 or 30 percent this year after losing more than that last year should hardly tempt investors back into the asset class on a continuous basis, although it appears that this is exactly what is happening.

Investors need to understand that the best way to invest in unsecured corporate debt is opportunistically – there are times to be long, times to be short, and times to be out of the market entirely. There are important signs of overvaluation and undervaluation in these markets that investors must be able to identify. Early this year was only a time of undervaluation with respect to the unsecured debt of borrowers that were not in imminent danger of default. And making that determination was dependent on two factors – first, whether the refinancing market would revive, which it did; and second, whether a specific borrower was capable of raising capital at a price it could live with. Those companies that could accomplish the latter saw their bonds rally significantly; those that couldn't have already defaulted or will do so in the near future.

HCM was not surprised in the least by the recovery of the secured debt market, which consists primarily of bank loans, which was beaten down to irrationally low prices by the financial crisis. Secured debt at the top of the capital structure was still secured debt with the first claim on a borrower's assets, and there was no reason that senior claims on assets should have traded down to 65 cents on the dollar. Much of the distress felt in the bank loan market was technical in nature (unlike that felt in the bond market, which was partly fundamental and partly psychological or hysterical in nature).

The largest buyers of bank loans leading into the crisis were Collateralized Loan Obligations (CLOs), which were shut down by the collapse of the Structured Investment Vehicles (SIVs) that comprised a significant part of the Shadow Banking System that caused so much of the damage to the global markets by concealing risk from the eyes of investors and regulators. Once CLOs stopped being issued on the order of \$100 billion a year, there were no new buyers for new loans. At the same time, existing CLOs were pressured by increasing holdings of loans rated CCC+ or lower, which had to be marked-to-market if they comprised more than a specified percentage of a CLO's holdings (generally 7.5 percent). This caused forced selling of CCC+ rated loans, which further depressed prices. A vicious circle was created that forced loan prices lower and lower. Adding to the pressure were the always helpful rating agencies who, having mis-rated virtually every financial instrument known to man the first time around, tried to make amends by mis-rating them again in a hopeless attempt to regain intellectual credibility and avoid political execution.

While these technical factors were depressing loan prices, however, many borrowers were continuing to service their senior debt without any problems, and a decent number of them were able to amortize some of these loans. As 2009 advanced, an increasing number of borrowers were able to access the bond market to raise capital to extend bank debt maturities or amortize loans, lending greater strength to the market. Investors who were able to look through the technical sell-off to the underlying credit quality of



individual loans fared quite well and profited without being stuck in lower quality holdings (unlike their unsecured brethren).

CLOs themselves are an interesting story. Based on our best information, at least half of all outstanding CLOs have breached covenants that restrict distributions to equity holders and/or the payment of fees to managers in 2008 and 2009.³ Fortunately, the strong rally in loan prices as well as exhaustion among the rating agencies resulting from downgrading virtually every borrower in sight have combined to give CLOs a considerable boost in recent months. The test that requires CLOs to mark-to-market their loans rated CCC+ or lower if they comprise more than 7.5 percent of their portfolio have become much less onerous with loans trading at much higher levels than in 2008 and early 2009. As a result, more CLOs should be able to return to compliance with covenants governing payments of distributions to equity holders and fees to managers.

KKR Financial Holdings LLC (KFN/NYSE), which we wrote about last month (and said was undervalued when trading at under \$1.00/share) is an interesting example of how CLOs can take advantage of improved market conditions to return to covenant compliance. Just to refresh our readers, KFN is the public company formed by Kohlberg, Kravis & Roberts to invest in CLOs that largely invested in bank loans issued by KKR portfolio companies. Since it went public several years ago, KFN's stock has lost virtually all of its value. On July 28, 2009, KFN announced that it had engaged in a series of transactions in which it eliminated a significant amount of the debt on its underlying CLOs. By shrinking the capital structures of these CLOs, KFN reported that it was able to bring them back into compliance with the covenants that were restricting distributions to the equity holders (as well as fees to KKR – the private equity firm is not a charitable institution). *HCM* had been waiting for KFN management to take a more aggressive stance toward its capital structure and welcome these moves. We think the stock now has the ability to move significantly higher (it closed at \$1.72/share on July 29, 2009).

Is China's Growth For Real?

Skeptics that we are, we have been bemused by the willingness of market observers to accept China's growth story at face value. At the very least, China's growth (like America's recovery) is largely attributable to massive government stimulus and is still lacking a sustainable domestic demand story. The stimulus plan announced by China's government last November amounted to a whopping 14 percent of GDP. As a percentage of GDP, that is three to four times the size of the U.S. stimulus plan. On July 15, 2009, China reported a 7.9 percent growth rate for the second quarter of 2009 compared to the same period a year earlier.

Our concerns about the quality and sustainability of China's growth were confirmed by someone whose views we admire very much and from whom we unfortunately hear from all too rarely these days, Morgan Stanley's Steven Roach. He warned in the



Financial Times on July 29, 2009 that he was beginning to worry about the China growth story. His concerns arise from the short-term nature of China's fiscal stimulus package and the fact that a public capital expenditure drive has accounted for 88 percent of Chinese GDP growth this year, a clearly unsustainable pace. Mr. Roach points out that China accounted for two percent of global economic growth in the second quarter of 2009 and contributed significantly to export growth throughout the rest of Asia. In other words, little of China's growth has come from sustainable domestic sources, and the end of government spending could spell trouble not only for China but for the rest of Asia and the world. Without China's Herculean stimulus, the global economy would be considerably further behind the curve on the road to recovery.

China is succeeding in inflating asset prices through the infusion of massive amounts of money into its economy. In June 2009, the Chinese money supply measure known as M2 surged by 28.5 percent over June 2008, according to John H. Makin, a visiting scholar at the *American Enterprise Institute*. New bank loans rose by \$1 trillion during the first half of 2009. The problem is that there do not appear to be enough productive uses for this much money in such an abbreviated period of time. Keep in mind that this money really can't leave China – China is a closed economy and the money is basically trapped inside the country. Accordingly, it is now sloshing around looking for someplace to be spent. Much of the money has been loaned to state-owned enterprises, which are hardly models of economic efficiency (this is eerily similar to federal dollars in the U.S. being sent to states and local governments, isn't it?). Some of the new flood of money is finding its way into China's overheated stock markets, property markets, commodity markets and consumer durables (some of which are sitting unused after being purchased for homes that are not yet electrified). This does not appear to be a recipe for sustainable growth.

While providing a short-term boost that offers hope for those around the world grasping for green shoots, China's stimulus is more likely a recipe for inflation and ultimately for boom and bust. *HCM* has always believed that China would be a story of booms and busts, and recent activity seems to support this view. Recent unrest in China's provinces is likely a coincidental indicator of the difficulties inherent in managing such a vast economy. Investors in China should proceed cautiously and look under the surface to understand the real forces driving growth. If China is the future of the world, as many believe it is, the future may not be as great as it's cracked up to be. Future economic growth certainly isn't going to be as smooth or simple as some would like it to be.

The Next Black Hole?

The world outside Wall Street has finally discovered the world of dark pools and high frequency trading. The question *HCM* would like to pose is whether these latest twists on Wall Street's proclivity for opacity and speculation will be the next black hole that swallows the markets and the economy along with them?



Dark pools are electronic trading networks that allow institutional investors to buy and sell stocks anonymously. These networks allow investors to conceal their identities as well as the number of shares they are buying or selling. Readers may have heard of some of these networks – Goldman Sachs operates one called SIGMA X, for example, and there are others called Liquidnet, BATS and Direct Edge. According to *The Economist*, there are currently forty dark pools operating in the United States that account for an estimated 9 percent of traded equities. Other sources estimate the volume to be higher, which highlights the question of how anybody can know exactly what is going on in these hidden corners of the investment universe when their very *raison d'être* is to conceal information from the eyes of regulators and investors. Wall Street loves these private trading networks, where business is booming and profits are growing. *HCM* will go on record as saying that dark pools are a singularly bad idea from a systemic standpoint because they suppress the very transparency that builds confidence in markets.

High frequency trading is a phenomenon that often takes place on these dark pool exchanges. Actually the correct term is “high frequency algorithmic trading” since it is a trading strategy based on using algorithmic formulas to analyze market data and then predict and exploit likely market movements. It is another manifestation of the quantitative trading strategies of which *HCM* has been critical before. *HCM*'s view of this type of investing is well-known – quantitative trading is nothing more than mere speculation and adds nothing to the productive capacity of the economy. Moreover, in recent years we have seen the deleterious effects that these strategies can have on the markets by increasing volatility and causing securities prices to move without any connection to fundamental changes in the underlying company's financial condition. Proponents of these activities argue that dark pools enhance market liquidity, but liquidity without transparency is a sure-fire recipe for disaster. Add higher volatility to the mix and you have a singularly bad idea in our view. Why can't these trades be done with full disclosure and in the full light of day? How does hiding these trades in the shadows enhance liquidity or market stability?

No less than Paul Wilmott, a highly respected figure in the quantitative investing world (and founder of the quantitative finance journal *Wilmott*), warned of the dangers of high frequency trading in a recent opinion piece in *The New York Times*: “Thus the problem with the sudden explosion of high-frequency trading is that it may increasingly destabilize the market. Hedge funds won't necessarily care whether the increased volatility causes stocks to rise or fall, as long as they can get in and out quickly with a profit. But the rest of the economy will care.”⁴ The economy will care because the financial markets do not simply provide an outlet for financial speculation; like banks, they also provide a public utility function whereby they serve as a source of growth capital for companies. Dark pools are private playgrounds that hedge funds and investment houses use to trade in secret; allowing them to operate is singularly bad public policy. As we saw last year, when the markets fail and can no longer perform their public utility function because of damage caused by excessive speculation, the



economy suffers severe damage. One of the best ways to insure the healthy operation of markets is to require them to operate transparently, and high frequency trading on dark pool exchanges are designed to do precisely the opposite.

High frequency trading recently attracted attention when the media-shy senior Senator from New York, Charles Schumer, threatened to introduce legislation banning the practice of “flash orders” if the Securities and Exchange Commission (SEC) didn’t take immediate steps to outlaw the practice. Flash orders are a particularly noxious Wall Street invention in which dark pool exchanges allow traders to briefly see and react to certain orders ahead of the rest of the market. This is commonly referred to as “front-running” in financial markets where the securities laws are enforced. As we have come to learn with laws governing abusive practices such as naked short selling, however, sometimes the securities laws in the United States are enforced, and sometimes they aren’t. As *The Wall Street Journal* matter-of-factly stated the matter, “[t]he SEC is looking into the practice and is widely expected to ban it, according to people familiar with the matter.”⁵ Oh really? The SEC is behind the curve and needs to catch up quickly.

The very name “dark pool” says it all – these off-market exchanges are antithetical to the transparency that should be the basis of financial markets. *HCM* has long marveled at the ability of these exchanges to proliferate under the noses of regulators without any investigation or opposition, particularly in view of the repeated disasters that off-balance sheet or hidden entities or activities have inflicted on the financial markets and the economy. We would say we were surprised, but how could we be surprised in view of the abject regulatory failures of recent years. This time, however, the regulators have a chance to prevent a potential train wreck before the train gets much further down the tracks. In order to do so, however, the Obama Administration is going to have to stand up to some very powerful financial interests on Wall Street and give the lie to the arguments that trading will flee to less regulated jurisdictions that will allow this kind of opaque activity. One can only hope that after the lesson of Enron (a company concealed material information from investors in off-balance sheet entities), which had to be learned all over again with the demise of SIVs (entities whose very purpose was concealing \$400 billion of risky assets from regulators, credit rating agencies and investors), that the Administration will give its regulators the necessary backing to reign in these secret trading exchanges.

In an era in which corporate bond trading has been forced into the open through the introduction of the TRACE system, which requires broker-dealers to report all public bond trades within a few minutes of execution, it makes absolutely no sense to permit large parts of the equity markets to retreat into the shadows. It would be an important step on the part of the Obama Administration to end to the intellectual Balkanization of financial regulation by treating debt and equity markets the same and forcing trading in both markets into the open. How many times are we going to tempt fate?



Leszek Kolakowski (1927-2009)

One of the major European intellectuals of the second half of the 20th century died quietly in Oxford recently. Leszek Kolakowski is largely unknown in America, but his work served as an important influence on the intellectuals in Poland's Solidarity Movement that led to the overthrow of communism in that country. He was awarded the first Kluge Prize from the Library of Congress in 2003 bestowed for lifetime achievement in those fields of scholarship (the humanities above all) for which there is no Nobel Prize. Professor Kolakowski's most influential work was his massive study, *Main Currents in Marxism* (1976), in which he examined the flaws of the ideology that caused so much suffering in the 20th century. He treated Marxism with the seriousness that it deserves as an analysis of how capitalism works, but he also called Marxism "the greatest fantasy of our century." He argued that the tyrannies to which it gave rise were the logical outcome of Karl Marx's call for a vanguard of intellectuals to rule. Professor Kolakowski was a humanist, a philosopher, a historian of philosophy, and an important Catholic thinker. I first read Kolakowski as a student at Brown University when I picked up a book of essays entitled *Towards a Marxist Humanism*. Above all, I remember the humanity with which Professor Kolakowski engaged the world. Ironically, it was a young Karl Marx who wrote: "Philosophers have interpreted the world in various ways, the point however is to change it." Leszek Kolakowski was the rare intellectual who succeeded in both interpreting and changing the world.

He will be sorely missed but his words will live on.

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Notes:

1. Frederic Jameson, *Postmodernism or, The Cultural Logic of Late Capitalism*, (Durham, North Carolina: Duke University Press, 1991), p. ix.
2. Thanks to Christopher Wood's *GREED & FEAR*, July 30, 2009 for all of this real estate data.
3. *HCM* is happy to report that the two CLOs managed by Harch Capital Management, LLC have not breached these covenants.
4. Peter Wilmott, "Hurrying Into the Next Panic?" *The New York Times*, July 29, 2009.
5. *The Wall Street Journal*, July 30, 2009, "NYSE's Fast-Trade Hub Rises Up in New Jersey," p. C1.



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