



Man Up!

By Michael Lewitt, Editor, Editor, The HCM Market Letter

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“I think you are dead while you are alive. More and more I think society is made up of people like you. You take risk unconsciously. When you are in the town, or driving your car, you take risk but you don’t think about it. Now you are with me, and this is a conscious risk, you say you will not take it. But if you do not come, you will feel bad. Will you take it?”

Charlie English¹

The inmates have taken over the asylum

It is going to be virtually impossible for anyone, including the Chinese who hold our debt or the investors that the government wants to start taking risk, to regain confidence in American capitalism as long as the American Congress continues to act like the inmates of Bedlam. It is one thing to express moral outrage at the excesses and abuses that brought the economy to its knees, but quite another for legislators to completely disregard the law or suggest that the targets of their wrath commit suicide. Yet members of Congress did both when they learned that AIG was paying bonuses to the individuals who were largely responsible for blowing up the insurance giant. Senator Charles Grassley’s suicide call will undoubtedly go down as proof that just when you think public discourse in this country can sink no lower, a prominent public servant or personality will prove you wrong. At the rate we are going, President Obama will have to establish a line item in the budget for a staff psychiatrist to be put “on call” for Congress. Congress is as responsible as any entity for the regulatory policies and lapses that led to the current financial collapse. Instead of trying to divert attention from its own failures, it should be apologizing to the American people and moving with all

¹ Charlie English, [The Snow Tourist: A Search for the World’s Purest, Deepest Snowfall](#) (Portobello Books: London, 2008).



deliberate speed to implement responsible policies to move this nation forward. Such policies do not include an earmark-laden stimulus bill, a confiscatory ex-post facto tax on financial executives, or a continuous trail of show trials intended to publicly humiliate men and women who are no more culpable than the members of Congress of creating this mess. It is time for Congress to take a deep breath, man up, and start solving problems instead of creating new ones.

The Fed steps up

Nobody can complain that the Federal Reserve isn't manning up. On March 18, 2009, the Fed announced that it would begin quantitative easing (the outright purchase of government securities), which triggered a sharp drop in the dollar and U.S. Treasury bond yields. The central bank announced that it will increase its purchases of agency mortgage-backed securities by \$750 million to \$1.25 trillion this year, and purchase up to \$300 billion of Treasury securities over the next six months. The 10-year Treasury bond yield dropped 47 basis points on the news to 2.53 percent, the biggest daily decline since October 1987. By the opening of trading on March 31, the yield had recovered to 2.74 percent in part due to a very poor 5-year Treasury auction last week. Part of the reason for the immediate plunge in yields after the Treasury's announcement was that it was a surprise; there was little indication that the Fed was ready to make such a drastic move, although it makes sense in the context of trying to keep mortgage rates down.

PPIP (sounds like...)

The Treasury's dramatic announcement was followed a few days later by Treasury Secretary Geithner's unveiling of the Public-Private Investment Program (PPIP), the Obama Administration's plan to finance a public-private partnership to purchase toxic assets from banks. Like many unveilings, this one left many of the explicit details in the shadows and full denuding is still several weeks away. *HCM* views this plan with deep reservations. On the surface, the new administration appears to be pulling out all the stops to address the worst economic crisis in nearly a century. But a careful examination of the plan causes us to suspect that it is another example of a plan devised by the government in cahoots with elite financial interests that favors a small group of insiders at the expense of the American taxpayers. Furthermore, we view the plan's prospects of actually succeeding in purging bank balance sheets of toxic assets and then leading banks to begin lending again to be extremely dubious.

The Nobel Prize-winning economist Paul Krugman has opposed this plan based in part on the argument that it offers a one-sided subsidy to a select group of institutional investors. In a recent column ("America the Tarnished," *The New York Times*, March 30, 2009), Professor Krugman referenced a recent article in *The Atlantic* by economist Simon Johnson which states the case quite compellingly. Mr. Johnson is a former chief



economist of the International Monetary Fund and is now a professor at M.I.T. (it isn't Brown, but we won't hold that against him). He characterizes America's current crisis as one of crony capitalism, writing that "elite business interests – financiers in the case of the U.S. – played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive."

HCM has deep reservations about a plan developed by lifetime regulators and academics – however well-intentioned and intelligent they may be - consulting with self-interested private sector actors who would be the primary participants to profit from the plan. The government isn't even being particularly subtle in trying to disguise this. In order to qualify to purchase these assets, a firm must have over \$10 billion in assets under management, which disqualifies all but a very few firms from participation. Moreover, the government is limiting the number of firms that can participate initially in one part of the program, the Legacy Securities Investments Funds, to only five. Some will argue that as a matter of convenience the line of participation had to be drawn at a relatively high level, but this will be the first time when large size or wealth has been a positive qualification in the Obama Administration's policy calculus.

We then have the issue of the government creating a "heads-the-investor-wins, tails-the-taxpayer-loses" regime for attracting capital to purchase these toxic assets. *HCM* questions how many participants will be attracted to these assets in the first place, other than self-interested firms that helped design it. The very egregiousness of the terms suggests just how toxic these underlying assets are. *HCM* also doesn't believe for a second the advertised rates-of-return being thrown around (i.e. 30 percent?). Finally, there is irony – bitter irony – in the high degree of leverage built into Secretary Geithner's program. On a basic philosophical level, it seems illogical to think that highly leveraged investments in highly risky illiquid assets that are themselves inherently highly leveraged make sense. Usually, such assets attract unleveraged money that is prepared to buy and hold for a prolonged period of time and not be subject to the additional risks that leverage imposes. Of course, in this case, the U.S. government is ostensibly taking the leverage risk off the table, although it is not really being taken off the table, merely being shuffled from the investor's place setting to the taxpayer's place setting.

Furthermore, we have already seen the serious problems that can arise from so-called "public-private" partnerships. There are many examples to point to since the government has adopted such a model with respect to huge swaths of the financial sector. AIG is a public-private partnership – it is 80 percent owned by the government and 20 percent owned by U.S. taxpayers. The largest U.S. banks are public-private partnerships – the U.S. government has infused tens of billions of dollars of preferred stock into these institutions while leaving the dregs of common stock ownership in the hands of the public, their management and their employees. Citibank, Fannie Mae,



Freddie Mac – these are all examples of public-private entities that are neither fish nor fowl. The results have not been pretty, either in form or in substance. The refusal of the government to place substance before form has resulted in ugly incidents where private partners have rewarded themselves with taxpayer money in the form of bonuses that were undeserved, setting off a political and social backlash that has yet to run its course. *HCM* is speaking, of course, of the Merrill Lynch bonuses and the AIG bonuses (more on the latter below). Moreover, the government has simultaneously permitted the trading in the common stock of worthless enterprises (AIG, Citibank, Fannie, Freddie, General Motors, etc.) by economic actors that can only be described as speculators, which sends exactly the wrong message to a society that has been brought to its knees by rampant financial speculation. These are failed companies that but for government support would be in bankruptcy. It is a profound economic and moral error to treat them as going concerns in which people can continue to speculate. The seeds of the economic crisis were not only economic, they were moral. They lay in the way people came to behave, how they came to make promises they didn't intend to keep. The government is setting a very bad example by permitting these zombie companies to continue to haunt the earth.

Finally, *HCM* has written in earlier issues of this publication that we doubt that many banks are in position to shed these assets at anything near a clearing price because they remain marked at much higher prices on their books. Banks are not in a position to realize the losses that sales of these assets will trigger unless the government is prepared to somehow subsidize those losses. This creates the risk that the PPIP creates a subsidy on top of the subsidy that the government has already given the banks (and may have to continue to give those deemed too big to fail). *HCM* remains of the belief that the banks, especially since they continue to have private shareholders, should be left to work out their own problem loans without the additional subsidy of this new program.

PPIP is the latest instance in which we are continuing to socialize more risks than we are privatizing. Even worse, PPIP injects further leverage into the system, and further debt onto the U.S. balance sheet, at the worst possible time. This does not seem to be the type of policy response that the current crisis calls for.

AIG – put away your torches and pitchforks!

The torch and pitchfork brigade was out in droves after AIG announced that it was paying \$165 million in bonuses to the individuals in the Financial Products Group that made the bad investments that led the company to brink of bankruptcy last September. The real tragedy in this matter is the passivity of the Obama Administration in the face of bonus payments that are not only unjustifiable under any standard of reason but are also an offense to public policy. We are told that these payments must be made because they are required under employment contracts that AIG signed with the employees in question. That argument is eminently subject to question. But if these



contracts are to be nullified, it must be done within the confines of the law of contracts. Abrogating the law of contracts (as Congress has attempted to do) is an attack on the very system of law itself and destabilizes the system of capitalism. While capitalism has shown itself to be highly imperfect, it remains the best system extant in part because it has the ability to rely on a reliable system of laws that can't be changed arbitrarily or after-the-fact.

One of the basic tenets of contract law holds that contracts that are illegal or contrary to public policy are unenforceable. The most obvious examples of this are contracts for prostitution or contracts to purchase illegal drugs. But this legal principle also applies to contracts that otherwise injure society or the public good. It would seem to *HCM* that the most viable legal argument to attack the AIG employment contracts would be that they are against public policy because they are effectively taking public monies and using them in a manner that is injurious to society by rewarding conduct that was egregiously reckless. *HCM* would pay good money to see the attorneys for the recipients of these bonuses try to defend their clients' entitlement to these payments against such an argument. Much of the public anger and political backlash – which is falling largely on the Democrats – is based on the seeming impotence of the government in the face of this seeming theft of public money. It is disappointing that the minions of attorneys in the government haven't made this argument publicly.² Coming on the heels of the Merrill Lynch bonus rip-off, the Obama Administration is genuinely at risk of losing public credibility and control of the terms of the public debate over the economy. It is time for the administration to man up and take control of the situation. I was asked last week by several members of the media whether AIG is still too big to fail and responded that AIG already failed six months ago. The debate about whether the government should have bailed out AIG ended last September when the government made the correct decision to prevent the company from entering a free-fall bankruptcy that would have been, as I called it at the time, an "extinction-level-event" for the U.S. and global economy. The American taxpayers are already into AIG for \$180 billion (and

² *HCM* is obviously aware that this entire issue opens a huge can of worms. In *The King Report* (March 18, 2009), Bill King reported that some lawyers argued that trying to break the employment agreements would trigger standard cross-default provisions in AIG's derivative contracts that could place the company in default on billions of dollars of its cross-default agreements. On March 22, *The New York Post* reported that these cross-default provisions applied to any obligations in excess of \$25 million and that a secret "white paper" provided to the Obama Administration on this point convinced it not to challenge the bonuses initially. A few days later, *The Wall Street Journal* reported that a similar provision in the employment contracts for certain European AIG executives threatened to trigger almost \$300 billion of payments under credit default swap agreements. *HCM* finds these legal assertions to be highly questionable. As stated above, *HCM* believes that a solid legal basis for voiding these contracts exists in the contract law argument that these employment contracts violate public policy and therefore should be unenforceable. Accordingly, failing to enforce an unenforceable contract should not constitute a default that would trigger cross-defaults under the derivative agreements in question. *HCM* realizes that aggressive use of a public policy exemption to contracts raises serious questions about the sanctity of contracts into question, but this approach seems much sounder in legal terms than *ex post facto* tax confiscations or permitting sloppy contract writing from placing the entire Western financial system at risk (as the European employment contracts could apparently do). Law professors will be debating this set of facts for decades.



counting). The question now is how to wind down this company and minimize the damage.

In retrospect, the government would have been better served last September by providing a guarantee to AIG that would have preserved the insurance giant's credit rating. It was the threatened loss of the AAA credit rating that triggered the threat of bankruptcy since a downgrade would have required AIG to post tens of billions of dollars of additional cash collateral (that it didn't have) to support derivative contracts. The government made the cash available to post that collateral but did nothing to address the issue of the rating agencies continuing to lord themselves over the financial system without any checks or balances, something they continue to do today. Had the government exercised its emergency powers under the Federal Reserve Act to lend AIG its AAA rating and to prevent the credit rating agency downgrades, the cost to the taxpayers could have been reduced significantly. Swap counterparties would have been protected without the necessity of paying them tens of billions of dollars of cash immediately. It appears that many counterparties, including foreign banks and hedge funds that took business risk by trading with AIG, were made whole on derivative contracts in which the underlying debt obligations were not in default and have not yet defaulted. In effect, this means that the government prematurely made whole parties whose right to payment was triggered by the change in AIG's credit rating rather than a change in the underlying debt obligation that AIG was insuring. In present value terms alone this cost the government billions of unnecessary dollars. Not to put too fine a point on it, but there was another and less expensive way to skin this cat.

We are also learning more about the kind of risks that AIG Financial Products assumed. According to Bank of America/Merrill Lynch³, 70 percent of the firm's credit default swap portfolio (i.e. credit insurance portfolio) as of June 30, 2008 consisted of insurance for Regulatory Relief Capital. This was a product that provided relief primarily to European financial institutions through effectively structuring an underlying pool of loans into a first loss and second loss piece. Capital requirements under Basel 1 created an incentive for institutions to sell the second loss piece to AIG (or any other institution who would buy it), but Basel 2 subsequently eliminated the incentive to do this.⁴ European banks therefore had enormous exposure to AIG which created systemic risk to the European banking system (and therefore to the globally-linked financial economy) because an AIG failure would have placed all of those second loss risks back on the balance sheets of the European institutions that thought they had sold them off to AIG. This would have required these European institutions to raise significant additional capital to support these risk positions, something that would likely have been impossible at the time AIG was rescued and remains impossible today. The bottom line is that while there is uproar on Capitol Hill about tens of billions of dollars that were paid out to European banks with respect to credit default contracts on mortgage-related investments, it

³ Bank of America, *The Situation Room*, March 2, 2009, pp. 4-6.

⁴ Basel 2 eliminated the regulatory capital arbitrage that permitted institutions to offload regulatory risk by explicitly recognizing the higher credit risk in lower rated tranches, something Basel 1 did not do.



appears that a much larger bailout was taking place. This should surprise no one – this is the price of a globalized economy in which all of the major participants are intimately linked to each other through complex webs of relationships. If we save one, we save us all, and if we let one fail, we risk letting the entire system fail. Those are the tough choices facing regulators and elected officials.

The continuing travesty of the rating agencies

While the government has been talking about increasing regulation on virtually every participant in the financial sector, it has said little about the central player in the current financial crisis – the credit rating agencies. Moody's Investors Service and Standard & Poor's were the primary enablers of the structured finance debacle that created the subprime mortgage meltdown and the leveraged buyout bust. These agencies have been as busy as beavers lately downgrading virtually every financial instrument in the universe that they can get their hands on ("better late than never" should be their new business motto). This raises the question of why the rating agencies are being permitted to continue to ravage the financial markets without any oversight or consequence. It is apparent that the rating agencies' original credit judgments were profoundly flawed. Now the agencies are running amuck downgrading every structured product in sight in an act of self-flagellation that is causing serious damage to the markets for these instruments and the underlying securities that were securitized (mortgages, auto loans, bank loans, etc.). While the government is forced to resort to a questionable cash-for-trash plan that is likely to cost taxpayers hundreds of billions of dollars, it is failing to address a key factor that continues to diminish the value of the very assets whose values this plan is trying to prop up in the first place – Moody's and S&P.

Every time these self-appointed doyens of credit downgrade a structured product, they force its value down by creating new sellers (i.e. institutions that can't hold paper rated below a certain level). These two companies were essentially calling the shots with respect to when AIG would blow up last fall since ratings clauses in the insurance giant's absurdly structured credit default swap contracts were the provisions that forced AIG to beg the government for capital. Why is there any reason to believe that the rating agencies' models and judgments are any sounder today than when they initially rated these instruments? The downgrades are causing a cascading effect that is forcing prices down to levels that do not reflect the intrinsic value of these instruments or underlying securities and are causing forced selling that is only increasing pressure on the financial system. Again, the government should be using its emergency powers to bring some sanity to this situation. The rating agencies are the rotten core of this apple, but nobody wants to play Johnny Appleseed and rein them in. It is time for the Treasury Department, whose Securities and Exchange Commission oversees these credit rating agencies, to man up and deal with the real intellectual source of so much of the systemic damage we have experienced.



Institutional investors step up

HCM was pleased to read that Calpers, the largest public pension fund in the nation and one of the largest investors in hedge funds, is finally demanding that these funds adopt what *HCM* has always considered best practices in terms of fees and transparency. In a memorandum dated March 11, 2009, Calpers notified the hedge funds and funds-of-funds in which it is invested that they will have to lower their fees and make their investments fully transparent if they want to continue to manage the money of California's public employees. In particular, Calpers is demanding that performance fees be subject to clawbacks (i.e. repayment if positive performance in early years gives way to poor performance in later years) and be calculated based on periods longer than one year. Calpers is also demanding that these funds disclose what the money belonging to California's public employees is invested in. This demand for transparency was particularly overdue. Calpers spokeswoman Pat Macht said that "[t]he only issue that keeps hedge funds from providing security transparency is their lack of cooperation." *HCM* has long maintained that arguments by hedge funds that their positions are somehow proprietary is a bunch of hogwash, particularly as it applies to their own investors. If fund managers don't trust their own investors enough to tell them where their money is invested, they have no business taking that money in the first place! The only thing proprietary about a hedge fund manager's business is what the manager carries around inside his head. Finally, Calpers appears to be moving to investing in separate accounts rather than commingled funds, which is a prudent decision for a fund of its size. While funds that follow best practices in terms of governance, fees and transparency⁵ are appropriate vehicles for smaller investors, large investors such as Calpers are much better served by separate managed accounts that protect them against the decisions of other investors (i.e. withdrawals of capital at inopportune times) and generally have lower administrative costs.

The stock market rally

As we wrote last month, the stock market could experience a sharp rally from compressed levels at any time. The current rally is a classic bear market rally and we believe investors should use it to reduce their equity exposure. We believe the equity market will retest its lows in the months ahead after dealing with horrendous first quarter earnings, the likely (and necessary) bankruptcy filing of General Motors (and Chrysler), likely first quarter GDP growth of negative 7 percent (annualized), and other bad news. This rally was woefully premature, triggered by phony news regarding bank operating profitability (while ignoring ongoing balance sheet losses⁶) and grossly negative psychology that was due for a bounce. But there is nothing substantive in terms of earnings to support the Dow or S&P at current levels. At 800-820, the S&P is trading at

⁵ Needless to say, all funds managed by Harch Capital Management, LLC follow these best practices.

⁶ We also heard credible but unconfirmed reports that much of the profitability reported by banks may have resulted from the profitable unwinding of swap trades in which AIG was the counterparty (and incurred massive losses that the government will be eating).



13-15x most reasoned 2009 operating earnings estimates of \$55-\$60 (after backing out write-offs). That may seem reasonable to some but it seems unreasonable to us by a meaningful margin. Before the market can discount the future, which many regard as its proper function, it must be able to articulate the future, and right now it is incapable of doing that with any degree of certainty. The market certainly isn't in a position to forecast sustained operating earnings at a level that would justify current trading levels. For investors that are tripping over themselves to jump back into the equity market, we just have four words – *“Be careful out there!”*

The automakers and the banks

The Obama Administration deserves strong praise for rejecting the bailout plans submitted by General Motors and Chrysler. Neither of these companies should be given one more dime of government money until their capital holders have been wiped out. As *HCM* wrote last month, General Motors should only be restructured through bankruptcy. The company has no business continuing to pay hundreds of millions or billions of dollars of interest on bonds and loans that are worthless. The investors holding these instruments made a bet on GM and they lost. The fact that bondholders are able to delay the negotiations over a bailout proposal is laughable. These debts should be wiped out in bankruptcy.⁷ Chrysler is just another private equity deal gone bad that happens to be in the automobile industry. The thought of bailing it out without completely wiping out the equity and any other capital holders is unthinkable. Trying to push the problem off on Fiat SA is a typical investment banking concoction; Fiat has its own problems and merging it with another deeply troubled company solves nothing. The proposed transaction will only create a bigger mess to clean up in the end. Chrysler's business is simply not viable and should be liquidated.

HCM realizes that these are extremely harsh statements and that we will be accused of being too negative. It gives us no pleasure to make these statements. We have been arguing for years that the failure to take radical action would lead to this truly tragic moment for the auto industry, but our pleas fell on deaf ears. Politics and denial are responsible for this situation, not those of us who point out that a better result was possible had responsible action been taken earlier. At this point, however, anything less than a bankruptcy of General Motors and a liquidation of Chrysler will waste taxpayer money and keep moribund companies alive at a tremendous cost to the economy. America can't afford to have an economy filled with quasi-public companies being kept on life support by the government trailing little stubs of public stock behind them like turds in the dust (see the next page). The system must be purged, and the sooner this is done the better. We cannot be so afraid of failure that we pursue policies that guarantee failure. The manner in which the U.S. auto industry was permitted to

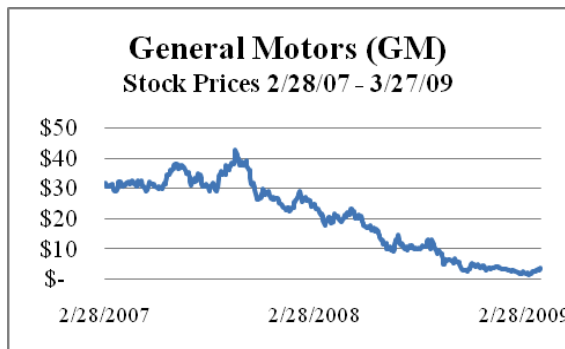
⁷ We would also add that the odds of Ford surviving outside of bankruptcy with its two main competitors filings and/or liquidating is virtually nil.

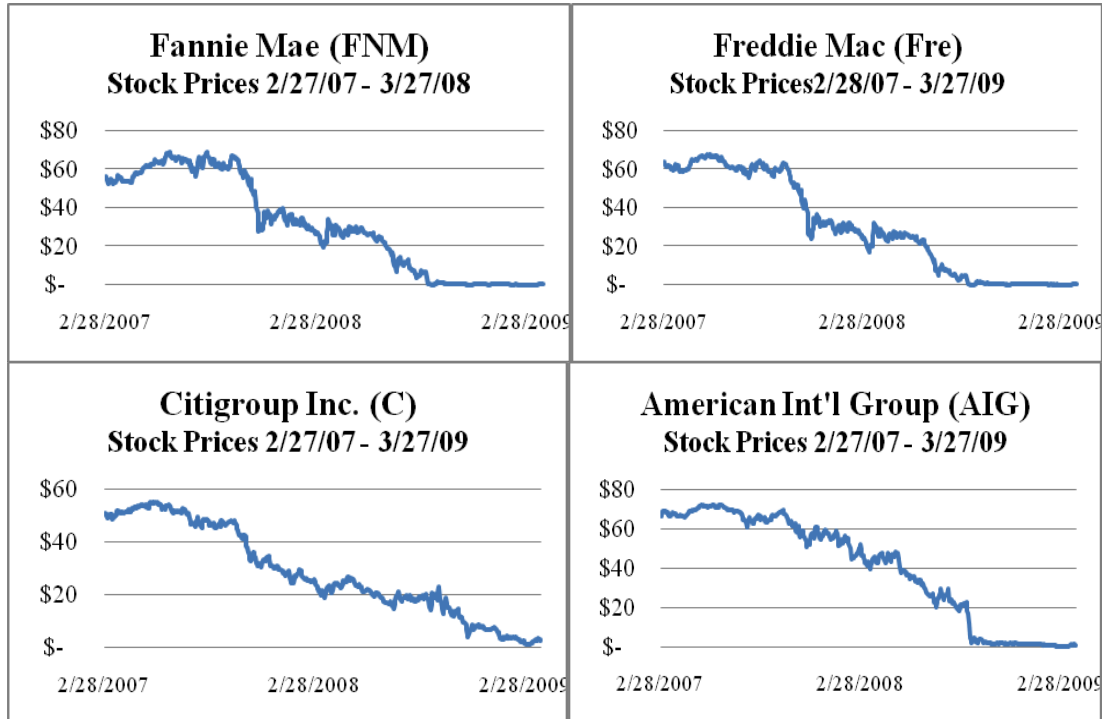


manage itself into oblivion by producing the wrong products with the wrong labor practices is a case study in how to assure failure rather than success.

HCM's greatest fear is that we are repeating this mistake with our handling of the banks. Too big to fail has somehow come to mean too big to regulate in this country. For years, Detroit's protectors in Congress blocked efforts to compel the Big Three to lower fuel standards and create products that could compete with foreign transplants in cost and quality. The industry's defenders were winning battles but losing the war. We need to ask ourselves if the same mistake is being made with the banking industry. While the problem is in certain respects different due to the interconnected nature of the financial system, it is similar in that it features political interests protecting the banks from genuine changes in their business practices (despite the phony torch and pitchfork skits being staged for the television cameras). The PPIP is a case in point, as was TARP. Perpetuation of the status quo seems safer, but in the long run it simply delays the kind of radical changes that can prevent the systemic collapse that was barely averted this time (and could still occur if, for example, the insurance industry comes apart all at once). *HCM* is not suggesting that the solutions are easy, or that those currently fashioning them are acting in bad faith. We are suggesting, however, that current problem-solvers appear to be captive to modes of thinking that created the problems needing solutions and may not be capable of thinking sufficiently outside the box emotionally or intellectually to design appropriately radical solutions to avert a true catastrophe in the not-too-distant future. Let's hope that the automobile industry isn't a dry run for the banking industry a few years from now.

A trail of public-private turds





Michael E. Lewitt
mlewitt@harchcapital.com



Disclosure Appendix

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Michael E. Lewitt, Editor

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