Shameless

By Michael Lewitt, Editor, The HCM Market Letter
April 13, 2010

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> "The problem wasn't that Lehman Brothers has been allowed to fail. The problem was that Lehman Brothers had been allowed to succeed."
>
> Michael Lewis[1]

In these two sentences, Michael Lewis describes what ails us. While most observers are still ringing their hands over the decision to allow Lehman Brothers to file for bankruptcy in September 2008, their outrage should be reserved for the personal and systemic lapses that permitted the firm's reckless behavior to destabilize the entire financial system.

The economy and the markets

While *HCM* has maintained that the global economy experienced a recession characterized by debt deflation that was not curable by conventional policy measures, it is becoming increasingly apparent that the steps taken by the world's central banks (and in particular the Federal Reserve) have succeeded in stabilizing matters. As a result, the depression-like aspects of the recession have been tamed, at least for the moment. This bodes well for financial markets and risk assets. This is in sharp contrast to what the Federal Reserve did (or failed to do) in the 1930s, and what the Japanese authorities did (or failed to do) over the past twenty years.

This does not mean that the fiscal train wreck in the United States has been set back on the tracks, or that the global imbalances that led to the financial crisis have gone away. Quite to the contrary. In fact, if progress isn't made with re-

[1] Michael Lewis, The Big Short Inside the Doomsday Machine (New York: W.W. Norton & Co., 2009).

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spect to these issues, and if intelligent financial reform is not enacted, future instability is guaranteed.[2] But for the next couple of years, the markets should avoid a crisis and offer significant investment opportunities.

Corporate credit

One potential crisis that may be pre-empted is the so-called "mountain of maturities" in high yield debt that is scheduled to come due between 2012 and 2014. During that period, something on the order of $600 billion of mostly LBO-related debt matures. Private equity firms are already working to refinance a lot of this debt. During the first quarter of 2010, a record $67.8 billion of high yield bonds were issued, according to Thompson Reuters. Default rates have dropped to below 5 percent from a peak of 14 percent globally in 2009 according to Moody's Investors Service, giving the market further confidence and momentum.

The main challenge to less-than-investment grade credit markets will likely be Federal Reserve interest rate hikes, which will cause mark-to-market losses mostly in higher quality (i.e. BB-type) names. For the most part, however, the market is likely to view such moves as indications of an improving economy, which should be viewed as positive for less-than-investment grade companies. Therefore, with high yield spreads still hovering at over 600 basis points above Treasuries, the outlook for this market remains positive. There is still room for meaningful spread tightening as long as the new issue market remains open.

The masochistic nature of corporate debt investors never ceases to amaze *HCM*, however. The return of dividend recapitalization deals in the private equity/high yield bond space and covenant-lite bank loan deals suggests that investors in these markets have memories no longer than the half-life of fruit flies. It is particularly notable that investors were willing to purchase low yielding bonds (8 percent yields) and covenant-lite bank loans in the highly cyclical chemical company Lyondell Chemical Company. Lyondell is emerging from bankruptcy under the control of private equity firm Apollo Management, which is notorious for its serial abuse of creditors, the enormous losses it suffered in its private equity and bank loan portfolios during the recent market crash, and its apparent involvement in the pay-for-play scandal in California. This is a classic case of what my grandmother used to say when she went to her favorite restaurant: "The food here stinks! And such small portions!" This suggests that the credit culture remains highly complacent, probably due to the fact that investors in highly risky, low-rated debt instruments were able to recapture much of their 2008 losses in 2009. But riding the elevator all of the way down to the ground floor in 2008 only to ride

[2] For an extended discussion of my views on financial reform, see my interview with Kate Welling in *welling@weeden*, "This Is Later," March 26, 2010. In that interview, I also discuss my forthcoming book, The Death of Capital, which is now available from your favorite internet bookseller and will be in bookstores in May.

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it back up to where they started in 2009 accomplished very little for their investors, and many firms were too highly leveraged in 2008 and were carried out of the market feet-first instead of having the opportunity to make the return ascension. It would seem much more prudent for investors to maintain credit discipline in a world that is still facing the headwinds of deteriorating fiscal conditions and private equity sponsors whose track record consists of making money by diminishing the value of the debt they sell to investors.

Housing

Higher Treasury rates could be troublesome for the housing market, which continues to disappoint (which is saying a lot considering it is disappointing from already abject levels). Mortgage rates are likely to be pressured by higher 10-year Treasury yields, which may explain the Obama administration's increased efforts to pressure banks into taking novel steps to help homeowners. Bank of America's program to provide principal reduction, a type of relief that *HCM* has suggested in the past, is likely to spread to other large lenders if the housing market continues to struggle. While such programs will hurt bank earnings, these institutions can take the pain now or take it later. They may finally become politically and economically astute enough to understand that it is in their interest to become part of the solution to the housing problem still plaguing the American economy.

The crowding-out effect

As noted in last month's issue of this publication, the crowding out effect of gargantuan government borrowing needs remains a wild card that could affect the corporate bond market and all other debt markets globally. Investors will be watching closely to see whether last week's relatively sharp rise in Treasury rates represented a signal that yields are breaking out or was just a trading move. *HCM* would advise investors to avoid government bonds, although by saying this we recognize that we are saying what virtually everybody else is saying.

Healthcare reform

One of the lessons from the ugly healthcare debate is that the American political system is increasingly incapable of dealing with complex policy issues. This is not merely a political problem; an inability to deal with important policy issues breeds a distrust in government institutions that harms economic growth. The lack of trust in government comes in different forms, from questions about the quality of information provided to the public by government institutions to fear that changes in the law will be arbitrary or unfair. As a result, businesses tend to hire fewer workers and fund fewer new projects in the face of such uncertainty. Concerns about the outcome of healthcare reform reportedly led many businesses to

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slow hiring plans, although whether this was truly the case remains to be seen. There can be little question, however, that confidence in government is a strong correlative of healthy economic growth and a cohesive and stable society.

In a more perfect world, healthcare reform would have been part of a comprehensive economic reform plan for this country that included reform of energy policy, tax policy, industrial policy and environmental policy. But comprehensive reform on such a broad scale is impossible in today's political climate, leaving us with piecemeal reform of large sectors of the American economy that are artificially separated from the rest of the economy in which they are embedded. But at its core, healthcare is an issue of economic security: the goal of healthcare policy should be to provide all Americans with assurance that they will have access to affordable healthcare when they get sick, and that the misfortune of physical illness will not lead to economic hardship. Energy policy is similar – it is really about access to affordable energy so that heating one's home or driving to work does not become an economic hardship (or worse, that the cost of transportation does not become a disqualifying factor in seeking employment).

Republicans and Democrats need to learn to frame the issues in these terms and then develop meaningful programs that are fair, affordable and transparent in order to regain the confidence of their constituents. This requires leadership of the type that President Obama seemed to offer during his campaign. Unfortunately, the president has fallen victim to the perils of partisanship. The result is a polity that is even more fractured than it was at the end of our last president's second term. America has survived worse, but nobody should believe that the current situation is healthy for the economy or the markets.

Financial reform

The current debate concerning financial regulation makes it abundantly clear that reforming the system is going to be extremely difficult. Preventing a recurrence of the types of reckless and selfish behaviors that led to financial instability is such a tall order because the forces that caused individuals to act badly are deeply embedded in human nature and in modern culture. One force that has acted throughout human history to tame the worst aspects of human nature is a sense of shame. As Michael Lewis argued in a recent interview about his book, shame is an attribute that is sorely missing on Wall Street (and, he could have added, in Congress and the rest of our society). When people have no shame, they have no limits. And when they have no limits, they (and the systems in which they operate) tend to run off the rails. In that interview, Mr. Lewis said the following:

> "There's a very obvious status structure on Wall Street…And when the people at the top set such a

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> bad example, everything else, in a weird way, follows from it.
>
> "I'd like the genuine elites to explain … why they behaved in the way they did. Because I think in the end, if you're going to get back to a saner relationship between our financial system and the rest of the economy and the rest of society, you have to have people at the very top of that structure who have some sense of social obligation. And they don't right now.
>
> "It's a question of how to restore that. And you restore it with shame, with a sense of you should be ashamed that you did not behave in the way you should have behaved. How do you fix that, how do we get you to reframe your relationship to the rest of society? That's where I'd go. That's who I'd like to see dragged in front of the public and have to explain themselves." [3]

A status structure based on moral conduct rather than wealth would rank our current elite at the bottom, not at the top where it currently resides. From the pay-to-play scandals that are disgracing some of the largest private equity firms in the nation, to the active and knowing participation of the country's largest financial firms in the subprime Ponzi scheme, there can be little question that American capitalism in its current form has become seriously corrupted. One of the driving enablers of this corruption is a complete lack of any sense of shame on the part of the business and political leaders who led the system to the brink of the abyss. Instead of acknowledgements of responsibility, these individuals offer excuses. Instead of stating the obvious – that they shouldn't be selling products with one hand and betting on their failure with the other – executives excuse their behavior by arguing that they are merely offering what the market will bear. As Michael Lewis noted, change needs to begin at the top or else the entire culture becomes dangerously dumbed down.

Moody's on private equity

Bankruptcy no longer bears the stigma of failure that it deserves for corporations that have borrowed too much or failed to say no to unrealistic union demands or otherwise failed to adjust to changing competitive conditions. In fact, bankruptcy has created an enormous moral hazard problem in Corporate America, particu-

[3] "Lewis Faults 'Short-Term Greedy,' Cites Goldman: Interview," March 15, 2010, *Bloomberg News*.

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larly with respect to the role played by private equity firms in restructuring bankrupt companies. The private equity industry traffics in bankruptcy on the way up (when it grossly overpays for companies in speculative transactions that serve no productive purpose) and on the way down (when it tries to make its lost money back by participating in their restructuring), and their investors nary blink an eye. All the while, on the way up and on the way down, these firms extract huge fees from these same investors. For those like *HCM* who view the so-called competition among private equity firms with a jaundiced eye, this entire enterprise looks highly suspicious.

Data contained in a recent report by Moody's Investors Service, another discredited organization that somehow keeps on going like the Energizer Bunny, confirms this view of private equity. Entitled "Private Equity 2009: Nearly Half of Defaults But Better-Than-Average Recover Prospects," the report reveals that nearly half of U.S. non-financial defaults in 2009 involved companies owned by private equity sponsors. Yet the report goes on to contend that the involvement of a private equity sponsor may benefit a company during times of distress and default due to the sponsor's access to capital, strong financial market relationships, and financial sophistication. These attributes, according to Moody's, enable sponsors to preserve value during periods of stress. Conversely, Moody's points out that the presence of a private equity sponsor can often be negative for creditors when a company is performing well since many sponsors engage in such anti-creditor behavior as paying themselves dividends through the incurrence of additional debt.

Most of Moody's report, aside from the statistics showing the high likelihood of defaults among private equity deals, demonstrates that the credit ratings firm has learned virtually nothing since it gave the same AAA rating that the U.S. government enjoys (for now) to trillions of dollars of subprime loans. In fact, some of the report reads as though it was written by somebody completely ignorant of the financial markets. Moody's argues that private equity involvement is positive for creditors because private equity-sponsored deals tend to engage in more out-of-court restructurings and distressed debt exchanges than deals without private equity sponsors. Moody's writes: "In a review of U.S. corporate defaults in 2009, we found a higher incidence of distressed exchanges and prepackaged bankruptcies among defaulted companies with PE [private equity] backing. These kinds of defaults tend to yield higher recoveries for creditors and preserve more value for private equity than restructurings in bankruptcy court. So while the interests of creditors and private equity might diverge when a company is healthy and throwing off cash, they tend to align when a company is in distress. At that time, both are interested in preserving value." This analysis shows a profound ignorance of the market. Moody's completely overlooks the fact that the original holders of debt often sell their holdings to distressed investors (some of whom are the same private equity firms sponsoring the failed deals in question) and are

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not the parties that enjoy the so-called recovery in value achieved through these prepackaged bankruptcies or distressed exchanges. Accordingly, a private equity firm's involvement in a failed deal rarely benefits the original debt holders. By failing to draw this distinction, Moody's presents a completely false picture of the market. The reality is that private equity sponsors have a strong economic incentive to reduce the value of the debt that finances their deals, as David Swenson, head of the Yale University endowment, has pointed out in the past.

Private equity regulation

Eighteen months after the collapse of Lehman Brothers, regulators on both sides of the Atlantic are still struggling with the issue of how to effectively regulate the private equity industry. The European Union appears to be far more serious about regulating this opaque and secretive industry than the United States and United Kingdom. The latter two countries remain highly protective of an industry that exercises undue political influence despite the damage it has inflicted on their respective economies. The dispute poses two threats. First, there is a real possibility that regulation will be diluted to the point that it will be completely ineffective. Second, both sides are making the types of protectionist noises that students of history would expect to see in the wake of an economic crisis but that are nonetheless alarming. Private equity, like any other industry, should enjoy open borders. The key is to insure that the industry is regulated in a uniform manner across all regions to prevent forum shopping and other abuses.

At the same time, some of the world's largest investors continue to spar with private equity firms over a proposed set of principles designed to even the playing field between investors and managers. Investors are represented by the Institutional Limited Partners Association (ILPA), which represents more than 200 of the largest private equity investors that control more than $1 trillion of private equity assets (at least that's what they say they are worth). Among the key changes being demanded by the ILPA are reductions in the egregious fees that are charged by private equity firms. The private equity industry has reportedly responded to these demands by seeking counsel regarding whether members of the ILSA such as CALPERS and Texas Teachers Retirement Fund have violated antitrust laws by consulting with each other and working together on the proposed set of best practices. This response is obviously not a study in the Dale Carnegie school of client relations.

On Tuesday, March 30, representatives of the ILPA met with leaders of some of the largest private equity firms in the world to discuss their relationship, according to *The Wall Street Journal* ("Big Guns of Finance Gather to Talk Terms," March 30, 2010, p. C3). *HCM* can only urge these investors to hold these firms to the standard to which fiduciaries are supposed to be held, something that has been strangely missing from their relationship thus far. The lack of transparency on

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valuations and fees that has characterized the private equity business for so many years is why the industry should be subject to the same types of regulation as hedge funds and other money managers entrusted with the capital of the largest investors in the world. After all, these investors for the most part represent pools of capital that belong to working people who have been largely disenfranchised by Wall Street in recent years.

As *HCM* discusses at length in The Death of Capital, the private equity industry has done its investors a disservice by charging high fees for mediocre returns over the years. Institutions that entrust the capital of their beneficiaries have every right to demand fair treatment, which includes reasonable fees and complete transparency regarding their investments. It is troubling, to say the least, that their private equity managers are resisting their demands for what should be the minimum that any fiduciary should provide to its clients. The sooner that these institutions begin to risk-adjust their returns (i.e. analyze them in terms of liquidity, leverage, concentration risk and fees), the sooner they will realize that they should take advantage of Groucho Marx's advice and stop clamoring to become members of a club that only wants to have them as members so it can take undue advantage of them.

Lehman: Even worse than we thought

Perhaps none of us should be too surprised by the revelations in the report of Anton Valukas, the examiner for the bankrupt Lehman Brothers Holdings Inc. Perhaps some were holding out hope that it was only incompetence and not actual wrongdoing that contributed to the collapse of the once-proud investment bank. But Mr. Valukas's report puts that hope to rest with a resounding and depressing thud. Mr. Valukas lays out in excruciating detail the deliberate steps taken by the firm's senior management – which included Richard Fuld despite his current denials[4] – to conceal the firm's true financial condition. In its second quarter 2008 earnings call, Chief Financial Officer Ian Lowitt, who had just replaced the obviously out-of-her-depth Erin Callan, claimed that Lehman had reduced its balance sheet leverage from 15.4 times to 12 times. This was a lie because Mr. Lowitt neglected to mention that Lehman had only achieved this by hiding $50 billion of assets in a temporary off-balance sheet transaction now and forever to be infamously known as Repo 105s. Lowitt's predecessor Callan failed to mention during an earlier call with analysts, which took place on March 18, 2008, that the firm had similarly concealed $49 billion of debt during the first

[4] Mr. Fuld is now denying – through a spokesperson – that despite his receipt of presentations including disclosure of the transactions in question, he doesn't use a computer and wasn't able to open attachments on his Blackberry. *HCM* does remember, however, a media report a couple of years ago in which Mr. Fuld did explain his addiction to computer games on his Blackberry, which are no more difficult to open than a simple attachment to an email. Perhaps Mr. Fuld should consider asserting his rights under the Fifth Amendment when he testifies this month before the House Financial Services Committee.

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quarter of the year. She did this while boasting that Lehman was "trying to give the group a great amount of transparency on the balance sheet." After a brief stint at Credit Suisse, Callan has mercifully left the securities industry.

Yet even more disturbing than these revelations is the possibility that the actions of Lehman's management may turn out to be defensible in a court of law. How is that possible? Well, it turns out that these accounting manipulations were done under the watchful eyes of government regulators. Andrew Ross Sorkin pointed out in a March 16, 2010 column in *The New York Times* that teams of government regulators were present at Lehman Brothers during the period when these Repo 105 transactions were executed. Then New York Fed President Timothy Geithner and then SEC Commissioner Christopher Cox had sent teams of examiners into the investment bank in early 2008 to monitor its operations (as well as those of Goldman Sachs, Morgan Stanley, Merrill Lynch and other firms). In his report, Mr. Valukas stated that, "[a] recurrent theme [of the Lehman Brothers executives interviewed] was that Lehman gave full and complete financial information to government agencies." These employees told the examiner, however, that "the government never raised significant objections or directed that Lehman take any corrective action." Mr. Sorkin points out that "when the bankruptcy examiner asked Matthew Eichner of the S.E.C., who was involved in supervising firms like Lehman, whether the agency focused on leverage levels, he answered that 'knowledge of the volumes of Repo 105 transactions would not have signaled to them "that something was terribly wrong"' according to the examiner's report."

In the midst of these revelations, SEC Chairman Mary Shapiro happened to be scheduled to testify before Congress and made the requisite mea culpa (in fairness to her, this did not happen on her watch). In one of the great understatements of 2010 (we are still early in the year), she described the SEC supervision of Lehman Brothers as "so terribly flawed in design and execution." This latest and perhaps most abject failure on the part of the agency ostensibly designed to protect investors can be attributed to one of two explanations. The first is that regulators deliberately decided that forcing Lehman into honest disclosure would have shaken the confidence of financial markets to an unacceptable extent. This explanation is consistent with the government's actions in other aspects of the financial crisis, specifically the unnecessary payments to AIG's swap counterparties that were not disclosed until well after-the fact. The second explanation is that the SEC personnel on the scene were simply incompetent and didn't understand the accounting fraud in which Lehman was engaged. This explanation is consistent with the SEC's failure to uncover the Bernard Madoff fraud and many other instances of SEC incompetence.

What is perhaps most appalling about the Lehman disclosures is how similar this fraud was to the schemes that brought down both Enron Corp. and WorldCom

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Inc. just a few years ago. In the case of Enron, assets were moved off balance sheet with promises that they would be repurchased by the parent company, allowing the company to misrepresent its true financial condition (which was rapidly deteriorating). The auditors, the now defunct Arthur Anderson, blessed Enron's transactions, just as Ernst & Young appears to have blessed Lehman's malfeasance. In the case of WorldCom, certain expenses were capitalized (i.e. spread out over a period of years) rather than deducted immediately as required by Generally Accepted Accounting Principles, creating the illusion that the company was more profitable than it really was.

There is an important difference, however. Unlike Enron and WorldCom, two large industrial companies, Lehman was a systemically important financial firm with links to virtually every other important financial firm in the world. As a result, Lehman's collapse posed a significant threat to the entire financial system. This was known (or should have been known) to Lehman's executives as well as by the regulators that were supposed to be watching them.[5] Finally, Lehman's management acted with the full knowledge of what had happened at Enron and WorldCom; instead of learning from history, they merely repeated it in a context that rendered their actions far more dangerous.[6]

China

This publication is obviously in need of a publicist. How else to explain the fact that or warning about a China bubble, which was delivered last summer,[7] has been completely overlooked by the financial press while others such as Jim Chanos (who we greatly respect) have gained attention for making similar predictions more recently. The most recent warnings in this respect came from Citigroup's economists in the United Kingdom, led by former Bank of England policy maker Willem Buiter, and by GMO's Edward Chancellor. According to Citigroup, it may take as long as two years for the asset bubble to form and at least three years for it to burst. Actually the bubble is already well in the process of forming, but more time will certainly need to pass until it bursts. The Chinese government has taken a number of steps to slowly let air out of the balloon, but these steps

[5] Accounts provided by Andrew Ross Sorkin in Too Big To Fail, Charles Gasparino in The Sellout and Henry Paulson in On the Brink make is abundantly clear that Richard Fuld was fully cognizant of the systemic as well as personal consequences of a potential Lehman bankruptcy.

[6] Some will argue that the proper accounting treatment of these transactions was a "gray area," but that completely misses the point that it was the non-disclosure of the transactions (and the assets), not the transactions themselves, that was duplicitous. Bart McDade, then chief operating officer of Lehman, viewed the Repo 105 transactions as "*another* drug we are on" (emphasis added) as he tried to stop their use, suggesting by his use of the word "another" that this was not the only funny business going on.

[7] *The HCM Market Letter*, "At the Risk of Repeating Ourselves," August 1, 2010, "Is China Growth For Real?" p. 5.

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pale in comparison to the stimulus that was injected into the economy in the wake of the global economic meltdown in 2008. China grew at 10.7 percent in the last quarter largely due to a $586 billion (4 trillion Yuan), two-year stimulus plan for railways, airports and homes. As a result, property prices in 70 cities rose 10.7 percent year-over-year in February. Mr. Chanos in particular has been focusing on the bubble in real estate prices and looking for investment opportunities to take advantage of that trend reversing sharply. China remains a command economy as well as a relatively closed economy whose currency remains artificially depressed in value. Nonetheless, China will not be able to violate the laws of economics forever.

Obama and Israel

HCM's fantasy is that the current strains in U.S.-Israeli relations are a carefully stage-managed affair designed to provide cover to the U.S. as it works to rein in the rising threat of a nuclear Iran. We are fairly certain, however, that the strains are real and that relations between the two allies have reached one of those difficult points that are inevitable in any complex relationship. As a steadfast supporter of Israel for moral, religious and political reasons, *HCM* finds the Obama administration's reaction to the unfortunate timing of Israel's announcement of the construction of additional homes in East Jerusalem to be at best an overreaction. Israel has been building in East Jerusalem for 40 years, and while *HCM* opposes continuation of settlements in the name of peace, we must also express our profound doubt that Israel now has or will ever have a partner for peace in the Palestinians. Accordingly, anything other than firm American support for Israel is both strategically and morally wrong. The administration's harsh tone toward Israel looks particularly misguided when contrasted with its treatment of such countries as Syria and Libya (to whom our State Department spokesman inexplicably apologized after criticizing for statements by its leader declaring a fatwa against Switzerland).

HCM would have thought that experienced hands like Joe Biden and Hilary Clinton would have done a better job preventing an inexperienced president from mistreating its most valuable ally in the Middle East. When push comes to shove, and it no longer becomes possible to look the other way or cling to the hope that sanctions will dissuade Iran from moving forward with its nuclear ambitions, President Obama will be coming hat in hand to the Israelis. The Israelis will do the right thing, not only because it will be right for Israel, but because it will be right for mankind. Obama should remember that the next time he grows frustrated with the leaders of a country that, unlike the United States, faces existential threats every day in its own backyard.

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The HCM Market Letter
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