



This is No Way to Run a Railroad

By Michael Lewitt, Editor, The HCM Market Letter
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“[C]rises are, in effect, not only inevitable but also necessary, since this is the only way in which balance can be restored and the internal contradictions of capital accumulation be at least temporarily resolved. Crises are, as it were, the irrational rationalizers of an always unstable capitalism. During a crisis, such as the one we are now in, it is always important to keep this fact in mind. We have always to ask: what is it that is being rationalized here and what directions are the rationalizations taking, since these are what will define not only our manner of exit from the crisis but the future character of capitalism? At times of crisis there are always options. Which one is chosen depends critically on the balance of class forces and the mental conceptions as to what might be possible. There was nothing inevitable about Roosevelt’s New Deal any more than the Reagan Thatcher counter-revolution of the early 1980s was inevitable. But the possibilities are not infinite either. It is the task of analysis to uncover what might now be possible and to place it firmly in relation to what is likely given the current state of class relations throughout the world.”

David Harvey¹

The misallocation of capital to speculative rather than productive uses is a great American tragedy. As described in detail in [The Death of Capital](#), the manifestations of this misallocation include most private equity transactions and the lion’s share of the derivatives and computer-driven trades of stocks and other financial instruments on the world’s securities markets.

The markets are dominated by investment strategies that have as their common denominator a reliance on momentum. There are many flaws in these strategies,

¹ David Harvey, [The Enigma of Capital and the Crisis of Capitalism](#) (London: Profile Books Ltd., 2010), p. 71.



beginning with the fact that they typify the “Greater Fool” theory. Adding insult to injury, the economy currently underlying the market is evidencing little momentum one way or the other. As a result, most investors have spent 2010 chasing their tails. Unfortunately, one of the most plausible arguments for believing that financial markets will rally is to endorse the view that investors will be as cynical and short-sighted in their thinking as their political and business leaders. That’s a hell of a way to run a railroad.

The railroad known as the United States economy is also chasing its own tail these days. Driven by misbegotten fiscal and monetary policies that ignore the lessons of history in favor of discredited financial and economic theories, the economy is trapped in a cycle of boom and bust. Every time the economy falters, our political leaders run to bail it out with politically-mandated Keynesian prescriptions that only exacerbate the underlying excesses and imbalances. Little or nothing is done to direct capital to productive uses and speculation is allowed to reign. As John Hussman recently wrote: “If our only response to excess consumption is to pull out all the stops trying to ‘stimulate’ consumption every time it falters; if our only response to reckless lending is to defend the bondholders every time their poor allocation of capital threatens to produce a loss for them, then quite simply, we will destroy our economy, our future, and our standard of living....[I]t’s difficult to envision a return to long-term saving, productive investment, and thoughtful allocation of capital until – as happens every two or three decades – the speculative elements of Wall Street are crushed to powder.”²

We have self-appointed diminutive macho-men like Rahm Emanuel barking about how crises are terrible things to waste while proceeding to do precisely that – squandering the opportunity that crises offer to effect meaningful reform by surrendering to special interests and lacking the courage to engage in genuine systemic change. The result – an expensive and profoundly flawed healthcare bill, an absurdly complex and at its core neutered financial reform bill – is not that the status quo is left in place but that it is made even worse. For this reason, the debates about whether the U.S. economy is enjoying a self-sustaining economy (*HCM* believes the recovery has been primarily government funded and is already fading as stimulus recedes) is primarily of short-term interest. In the long term, absent dramatic entitlement and other reforms, the economic outlook is bleak. There is genuine doubt concerning the ability of the U.S. government, as currently operative under the Constitution and other laws of the land, to deal with the mess in which we find ourselves.

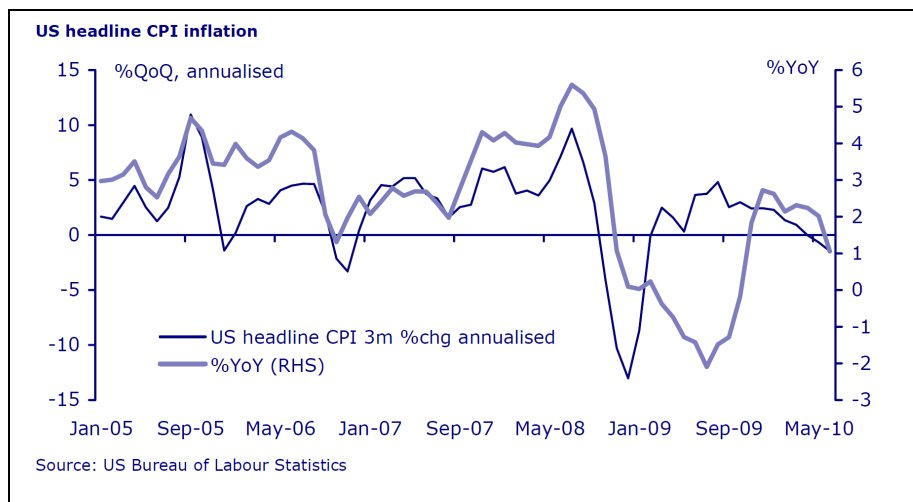
² John Hussman, “Misallocating Resources” July 12, 2010, *Hussman’s Weekly Market Comment*.

The economy

One of the reasons that financial markets struggled in the second quarter was that money growth stopped on the part of the government and the private sector did not pick up the slack. The result was an effective tightening in monetary policy that exacerbated debt-deflationary forces already at work in the economy. Indicia of this include the 10-year Treasury yield, which remains stuck around 3 percent (and is likely heading lower), and declining inflation.

Graph 1

Inflation is Dormant



US headline CPI dropped by 0.1 percent month-over-month in June and has now declined by an annualized 1.5 percent over the past three months. While this is hardly catastrophic, it is likely to trigger another bout of non-traditional Fed easing if it persists. This would be a policy error; the central bank should tolerate mild deflation to allow the system to purge at least some of the excesses of the debt bubble. The recent statement from the Federal Reserve Open Market Committee that “economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period” is clear evidence that the central bank is watching these inflation numbers closely and is unlikely to be satisfied with what it is seeing. Many highly respected observers expect the Bernanke-led Fed to engage in further unorthodox monetary easing if such trends persist. *HCM* would view such policy as an extension of the unwise pro-cyclical policies that have contributed to the boom-and-bust cycle in which we are stuck. If zero percent interest rates are insufficient to stimulate economic growth, then the answer is unlikely to lie in the realm of monetary policy. The answer is not, as John Hussman stated earlier, to engage in further easing machinations. The answer is to address other policy shortcomings in the fiscal arena, including tax and budget policies that reward speculation and punishes production.



The equity market

July was a strong month for equities, moving the S&P 500 closer to the upper end of *HCM*'s range of 975-1150 for the year. The market appears to have dismissed fears of a double dip recession, although the fourth quarter GDP report released last week suggests that the economy is slowing down. *HCM* is not expecting a double dip, but thinks the economy will struggle to grow beyond the 2.4 percent rate it preliminarily showed in the second quarter. Accordingly, our best judgment is that the projected upper end of our trading range (1150) will not be breached, but like many investors we feel like we are chasing our tails in making such a prediction since in today's computer-driven markets this level could be pierced in one over-heated computer-driven trading session. *HCM* does not think the stock market is particularly cheap in view of the economy's prospects despite relatively low valuations. We would also not dismiss the possibility of an extraneous event involving Iran or domestic U.S. politics from upsetting markets before the end of the year.

The bond market

HCM expects the bull market in bonds to continue through 2011 (and likely longer but forecasts seem to age in dog years so we will keep ours short) due to the presence of deflationary forces in the financial system. This is why we expect to see a 2.50% 10-year Treasury yield before long. There is still a great deal of bad debt to be purged from the balance sheets of both governments and global financial institutions, which will assert downward pressure on product and asset prices. David Rosenberg argues that the bond bull market will end "reasonably close to the point in time that inflation (or deflation) bottoms. That is because we have determined that by far the major economic factor that correlates consistently with the direction of market-determined interest rates, at least for long term Treasury bonds, is CPI inflation (headline and core)."³ Mr. Rosenberg's inflation forecast is 0-1 percent (actually declining from the current 1 percent to zero) over the next 12-24 months, which seems reasonable to *HCM*. He goes further, however, and makes the argument that prices are likely to remain low for a generation, by which he means around plus or minus 2 percent. In other words, he is proposing a Japan-like scenario. And he is not alone.

James Bullard, President and Chief Executive Officer of the Federal Reserve Bank of St. Louis, released a report last week entitled "Seven Faces of 'The Peril'" in which he wrote: "The United States is closer to a Japanese-style outcome today than at any time in recent history." Among the reasons given by those who dismiss the Japan-U.S. comparisons is that the political cultures of the two countries are very different, and that Japan's system is highly corrupted by one party government. *HCM* would take issue with that argument. Over the past decade, the U.S. political system has operated in as corrupt a manner as Japan's and has pursued many of the same profligate budget and spending policies that have sunk that country into economic mediocrity. U.S. authorities may have reacted more quickly than Japanese authorities to our crisis, but they did so in a highly unprincipled

³ David Rosenberg, *Gluskin Sheff Economics Commentary*, July 28, 2010.

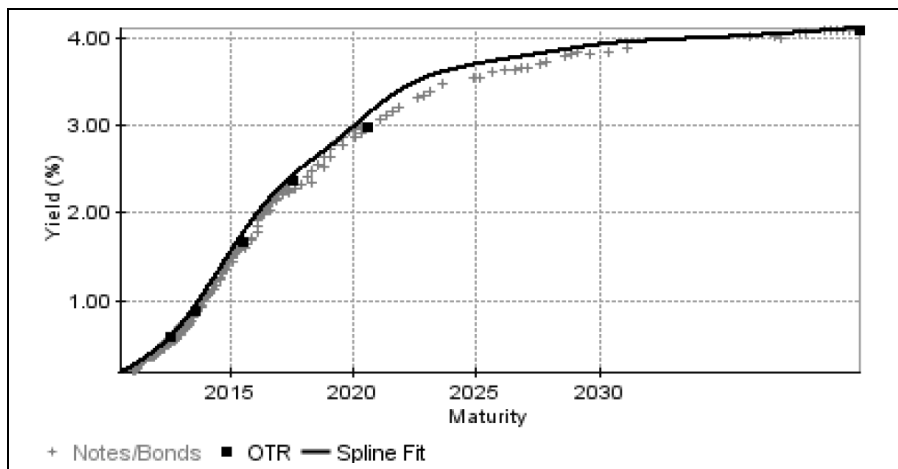


manner that in many ways rendered the U.S. financial situation more precarious. The comparison is becoming more valid by the day.

Japan's experience of the last two decades presents an object lesson in what the U.S. can expect in terms of sustained low interest rates and low or even negative inflation (i.e. deflation). Japanese government bonds (JGBs) have performed extremely well during this period, which has featured not only prolonged low interest rates but heavy government borrowing and an increasing ratio of debt-to-GDP. The United States has entered uncharted waters with respect to its growing deficits, and it remains noteworthy that Treasury yields have continued to decline in the face of huge current borrowing requirements and the prospect of trillion dollar deficits as far as the eye can see. The U.S. yield curve remains much steeper than the Japanese experience would suggest is justified, which offers investors who believe in the Japanese scenario an opportunity to earn excess returns. The yield curve seems to be signaling higher future rates and more Fed tightening than is likely. Japan has demonstrated that government bonds can rally even from what seem to be extremely low yields.

Graph 2

The yield curve – Steeper than it should be



Source: Credit Suisse

The dilemma for bond investors, however, is that it is difficult to get one's head around the attractiveness of lending money to the U.S. government for 10-years in exchange for a paltry 3 percent return. It is particularly galling for investors that are facing higher tax bills on their investment income and watching the government squander billions of dollars every day. Eventually, one would think, the consistent trashing of the dollar and out-of-control deficit spending should lead to inflation, which would be toxic for bonds. But eventually we will all be feeding daisies, and in the meantime there's money to be made. *HCM* believes



that Treasury bonds will continue to rally. The deflationary forces working their way through the economy remain extremely potent and should continue to depress yields for the foreseeable future.

European stress tests

While the media – particularly CNBC – seemed to want to pay a great deal of attention to the stress tests for European banks, nobody should have been particularly surprised or impressed by the results. The tests themselves were not a particularly vigorous attempt to evaluate the credit quality of Europe's banks; instead, they were a Potemkin's Village exercise meant to calm the markets. The real story in Europe is that the most stressed sovereigns – Spain and Greece – have been able to access capital with little trouble and at relatively attractive prices. This hardly means that these countries are out of the woods – Greece's 10-year yields remain in double-digits and the credit default swap market is still pricing in a 50 percent chance of default in the next five years. Spain seems to be in slightly better shape after taking significant steps to address its budget woes, although the country surely has far more to celebrate from the triumphs of Rafa Nadal and its World Cup Champions than from its economic future, which remains very challenging. Markets are paying attention to what is being *done* (successful capital raising by weak sovereign credits) rather than by what is being *said* (results of what are basically phony stress tests). That is the correct approach.

Yahoo! Inc. – Dying on the vine

Although she certainly had reason to do so, Yahoo! Inc. Carol Bartz did not curse out anybody on the second quarter 2010 earnings call in which she was called upon to explain another disappointing performance for her withering Internet company. Revenue growth search-ad sales were particularly disappointing. The company's stock dropped sharply after the release, falling 8.5 percent to below \$14.00. This is 27 percent below its 52-week high of \$19.12 reached on April 15, 2010. Yahoo! Inc. remains a short. When was the last time you chose Yahoo! Inc. as your search engine over Google?

Graph 3

Yahoo! Inc. – Yecch!



General Motors Co.

As one of the earliest predictors of a General Motors bankruptcy, *HCM* does not think it presumptuous to suggest that it speaks with some authority on the subject of the carmaker's current circumstances. Like many others, *HCM* was appalled at the Obama administration's abrogation of the rule of law during the bankruptcy process, although we also argued that the bondholders that were harmed by the administration's conduct had nobody to blame but themselves for wading into such politically-charged waters. Now we, along with everyone else, learn that the company is purchasing the subprime lender Americredit Corp. for \$3.5 billion to help it reach more customers with leases and loans. Readers will remember that General Motors lost control of its so-called crown jewel, the lender GMAC, which has lost billions of dollars making subprime mortgage loans and automobile loans. Rather than learn from its past mistakes, the company is apparently hell-bent on repeating them, this time under the aegis of the U.S. government. As Karl Marx taught us, history repeats itself, the first time as tragedy, the second as farce.

This acquisition raises many questions about industrial policy in today's America. It was already clear that the Obama administration is comfortable with deep government involvement in business. But having a government-controlled company make an acquisition – of a subprime lender no less – is a dramatic step further in that direction. General Motors is still deeply in hock to the American taxpayer, despite what can only be described as the willfully or egregiously misleading claims of its Chairman and Chief Executive Officer Edward Whiteacre this past April that the company had “repaid our government loan, in full, with interest, five years ahead of the original schedule.” In fact, General Motors had done nothing of the kind. It had repaid approximately \$7 billion of the almost \$60 billion of loans and other funds invested in the company by the government,



and used \$7 billion of TARP funds to do so. Mr. Whiteacre must think that the American people are complete idiots (not an entirely off-the-wall assumption in view of the leaders we keep electing). But the Obama administration, desperate for a win on the auto bailout, has not held him to account for this grossly inaccurate claim, and the liberal media has also given him a free pass. Instead, the administration and the rest of the administration's media cheerleaders are looking to an IPO to repay the rest of the government's investment, a highly dubious proposition. So what is the state of industrial policy in the United States today? Highly confused. And highly corrupted.

The Goldman Sachs "Settlement"

In the end, the settlement of the SEC's fraud charges against Goldman Sachs was the shittiest deal of all. The regulators brought a factually and legally deficient case, and the target, which has already suffered enormous reputational damage, settled for a mere pittance in dollars-and-cents terms. The entire exercise, it seems, was an effort to show the public that the government would no longer tolerate certain types of conflicted behavior on Wall Street. The effort, however, fell flat on its face. As noted in the last issue of this publication, Goldman Sachs would have likely prevailed on the merits had the case gone to trial. Settlement was a political, not a legal, decision; the firm did not want to be seen as showing up the government in view of the flood of negative publicity it had already received at the disclosure – news to nobody who does business with the firm – that it operates in a highly complex and conflicted environment in which it is obligated by the laws governing public corporations to act as a fiduciary for its shareholders first.

The \$550 million fine Goldman paid (we are sure it is pure coincidence that this amount was exactly the same as the amount of compensation Michael Milken earned in the mid-80s that doomed him to a guilty plea regardless of the merits of the case against him) cannot be understood as anything other than a slap on the wrist for a firm that routinely earns more than \$100 million a day in its trading operations. What did the government accomplish? Little more than demonstrating that the SEC's enforcement function remains extremely limited in a world whose complexity has outgrown the laws that the agency is charged with enforcing.

The private equity myth

Long-time readers of this publication are well-acquainted with *HCM's* dim view of the private equity industry. We view private equity as one of the great squanderers of capital in today's economy. It will not surprise anybody, therefore, to learn that we were suitably unimpressed by the stealth listing of KKR's shares on the New York Stock Exchange this past month. In fact, the almost embarrassed manner in which KKR listed its shares should serve as a sufficient reminder to investors that all previous stock offerings by private equity firms have been disastrous for public shareholders. The stocks of The Blackstone Group LP (BX), Fortress Investment Group (FIG), Apollo Management L.P. (AAA.EU) and KKR's European predecessor, KKR Private Equity Investors, LP (KPE.EU) have all traded off by



at least 50 percent since their initial public offerings. Going public has been favorable for insiders and treacherous to the financial health of outsiders.

I wrote about the imprudence of investing in private equity at great length in Chapter 5 of *The Death of Capital*. Others are now starting to see things my way. In late July, The Centre for the Study of Financial Innovation (CSFI) in London published a study entitled *Private equity, public loss* authored by former investment banker Peter Morris. This study reached virtually the identical conclusions to those argued in my book, even citing many of the same studies that have stripped the veneer from private equity returns to demonstrate that investors continue to get the short end of the stick while private equity insiders reap huge fortunes. Mr. Morris's study emphasizes the fact that so-called sophisticated institutional investors continue to get taken to the cleaners by the private equity industry. The disappointing returns that private equity has produced have rendered the very concept of "sophisticated investor" an oxymoron according to Mr. Morris. He writes:

“Even private equity supporters admit that three quarters of managers underperform public stock markets, despite using high leverage. The remaining top-quartile managers achieve part of their outperformance through leverage. Those who produce genuine operational ‘alpha’ may remove most of it in fees. And yet investment in private equity has continued to grow. This creates a ‘puzzle’.”⁴

A “puzzle,” of course, is similar to a “conundrum,” the word Alan Greenspan – ostensibly a very intelligent man – used to describe his inability to explain why his monetary policy was producing the opposite effect than intended. We should perhaps no longer be surprised that the gatekeepers and others entrusted with enormous responsibility in our financial system – regulators, pension consultants, institutional investors, policy makers and central bankers – operate under beliefs and assumptions that are completely divorced from reality. But we should not surrender to resignation and let them off the hook because they are killing capital.

Mr. Morris tries to be diplomatic in offering explanations for why so-called smart money is so dumb. “One possibility is that some investors may simply not understand. They may not realize that buyout returns have been less impressive than advertised.”⁵ He concludes that lack of understanding (i.e. stupidity) is implausible, so he tries again. “Another possibility,” he writes, “is that institutions which invest in private equity understand that the returns are inadequate, but persist anyway. For 30 years, investors have allowed buyout firms to present their returns in terms of the multiple [dollars invested, dollars returned] (which ignores the vital element of time) and the IRR (which generally overstates the realized return).”⁶ In other words, private equity investors are not stupid; they are merely

⁴ Morris, p. 37.

⁵ Morris, p. 37.

⁶ Morris, p. 38.



insane (they keep doing the same thing over and over again expecting a different outcome⁷).

The real reason so many institutions invest in private equity is that the asset class's opacity allows them to conceal their mistakes. Unlike public equities that do not give investors any place to hide, private equity can conceal errors for years. How many times have we heard excuses about how equity values are depressed for the moment but will eventually return to higher levels that will justify the initial investments? This is certainly the current excuse for all of the buyouts that were done at the peak of the market in 2004-2007 at ridiculously steep multiples with absurdly cheap capital (much of which has been lost whether buyout firms want to admit it or not). The equity value in most of these deals is currently zero and is unlikely to recover significantly. The truth is that private equity was another version of what I have described elsewhere as a "reverse Black Swan model" in which managers offered investors the illusion of steady returns with low risk when the reality was that the returns were poor and the risks were huge.⁸

Mr. Morris repeats the arguments made in The Death of Capital that private equity returns are less attractive than the same returns that could be achieved by investing on a leveraged basis in the S&P 500, particularly when these opaque returns are properly adjusted for leverage, concentration risk, liquidity and fees. Even more problematic is the fact that today, a significant percentage of these returns are being produced by private equity firms buying and selling companies to each other. According to *The Wall Street Journal* ("Private Equity's Strong Appetite for Seconds," July 28, 2010, p. C16), 35 percent of private equity purchases thus far in 2010 have been these kinds of pancake-flipping exercises. This is hardly conducive to economic growth or productivity enhancement. As with so many Wall Street-promulgated investment products, a studied analysis of private equity strips away any pretense of a reasoned basis for institutions directing so many billions of capital into such an unproductive activity.⁹

⁷ This definition of insanity has been attributed to Albert Einstein.

⁸ For a fuller discussion of this topic, see Chapter 7 of The Death of Capital. I would just add that it is also a fallacy to believe that private equity adds diversification to a large institutional portfolio. Private equity is just another form of equity and valuations and performance track those of the public equity markets. Accordingly, Mr. Morris's argument that institutional investors invest in this asset class as a way of limiting career risk because private equity offers disguised exposure to a leveraged investment in equity markets, if correct, may have some merit but describes behavior that is imprudent and ineffective and merely up the equity ante for institutional portfolios. Furthermore, as I have argued in The Death of Capital and in this publication, the concepts of diversification and correlation no longer mean what they used to; most asset classes tend to move in the same direction in today's globalized and correlated electronically-driven markets.

⁹ The Private Equity Council, a lobbying group that represents thirteen of the largest private equity firms (including KKR, Blackstone, TPG, Carlyle and Apax) predictably challenged the results of Mr. Morris's report (there have been no responses by this group to The Death of Capital other than its refusal to debate me on CNBC on the subject of the carried interest tax). The group claimed that performance measures from a number of consulting firms such as Cambridge Associates, Thomson Reuters, Preqin and State Street show the private equity industry outperforming the public equity markets. HCM would love to see these studies, which we don't believe for a second. The lobbying group also proffered a number of lame arguments claiming that private equity firms' interests are aligned with their investors, a point belied by the fact that the firms' principals continued to make out like bandits in 2008 by earning large management fees while their investors found themselves tied up at the side of the road with their pockets emptied. Anybody



Another important criticism made by Mr. Morris in his report is the poor quality of reporting by the publicly-held private equity firms. He makes a particular point of pointing out that The Blackstone Group likes to speak in its marketing materials about the fact that it would rank number 13 in the Fortune 500 (which ranks companies by revenue) yet engages in disclosure that is confusing and highly selective and therefore misleading to investors. He writes: “Blackstone wants to have its cake – Fortune 500 size and status – and eat it, by not having to report on a consolidated basis. Instead, its reporting is closer to that of an investment trust. That should not be acceptable.”¹⁰ Amen. Poor disclosure is just one of many reasons why investors should avoid private equity stocks.

Private equity bovine Apollo Management, which plans to follow KKR in listing its stealth European shares on the New York Stock Exchange, appears to have recovered from a near-death experience during the financial crisis. Apollo managed its recovery on the backs of debt holders, however, pointing to the fact that the private equity business has inflicted massive losses on virtually every constituency with which it has come into contact over the past five years. Apollo, like the other buyout giants KKR, Blackstone, TPG, Bain, etc., was hurt by overpaying for companies at the peak of the market – companies, by the way, that had no strategic reason to go private. In fact, these transactions accomplished little more than to substitute debt for equity on their balance sheets, devastate companies’ ability to compete in a global economy, and line the pockets of short-term oriented public shareholders and the general partners of the buyout firms purchasing them. This buyout frenzy inflicted untold pain on the U.S. and European economies that will be felt for years to come. The fact that Apollo can now tell its investors that it is out of the woods should be cold comfort for anybody that cares about the future of America’s economy (and ignores the massive losses the firm suffered in 2008). Moreover, as unwitting as the institutions that fund these buyout firms have been, those who lend to them are even more clueless. Apollo has been a serial abuser of debt holders for years, figuring out clever little ways to weave its way through complex covenants or drafting covenants in ways that are wholly deleterious to the interests of those who are foolish enough to lend them money. If this is what capitalism has come to in the first decade of the new century – and *HCM* fears that it is – we are in very deep trouble.

On occasion, private equity firms do build businesses and add to the productive capacity of the economy. One (all too rare) example of this is the investment by Leonard Green & Partners in Leslie’s Poolmart. The buyout firm bought this business in the late 1990s and held it for almost 15 years before quietly putting it up for sale recently. During that time, the business grew significantly, creating jobs and introducing new stores into neighborhoods around the country. Leonard Green & Partners’ investment returns have consistently outranked larger and better-known firms that have focused on going public or enriching themselves through dividend deals and other unproductive activities.

who is prepared to rely on The Private Equity Council for an unbiased view of the private equity industry would have happily trusted *Pravda* to track Russian troop movements during the Cold War.

¹⁰ Morris, p. 36.



Unfortunately, Leslie's Poolmart will likely end up in the hands of another private equity firm that will not treat it as well as its original owners. But at least there are those rare private equity firms that understand that private equity can act more in the nature of venture capital than robber barons.

Education in America - A book recommendation

My friend Mark Taylor, Chair of the Department of Religion at Columbia University and one of the true renaissance men in the academic world, is publishing a new book on the declining state of American higher education: [Crisis on Campus: A Bold Plan for Reforming Our Colleges and Universities](#). Mark makes the very powerful argument that "[j]ust as investors borrowed more and increased leverage to invest in volatile markets, so many colleges and universities are borrowing more and betting on an expanding market in higher education at the precise moment that their product, however valuable, is affordable for fewer and fewer people." Furthermore, in a disturbing example of one hand not knowing what the other is doing, many major universities are expending serious efforts on attracting foreign students to study in their new and expensive facilities while our nation's immigration laws do not permit these same students to remain in this country after they graduate to ply their skills! Mark's book should be required reading for anybody interested not only in higher education but in the road forward to a more productive and egalitarian society.

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Disclosure Appendix

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