The HCM Market Letter

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Why We Must Fix It

"Society is indeed a contract. Subordinate contracts for objects of mere occasional interest may be dissolved at pleasure – but the state ought not to be considered as nothing better than a partnership agreement in a trade of pepper and coffee, callico or tobacco, or some other such low concern, to be taken up for a little temporary interest, and to be dissolved by the fancy of the parties. It is to be looked on with other reverence; because it is not a partnership in things subservient only to the gross animal existence of a temporary and perishable nature. It is a partnership in all science; a partnership in all art; a partnership in every virtue, and in all perfection. As the ends of such a partnership cannot be obtained in many generations, it becomes a partnership not only between those who are living, but between those who are living, those who are dead, and those who are to be born. Each contract of each particular state is but a clause in the great primaeval contract of eternal society, linking the lower with the higher natures, connecting the visible and invisible world, according to a fixed compact sanctioned by the inviolable oath which holds all physical and moral natures, each in their appointed place."

Edmund Burke, Reflections on the Revolution in France (1790)

Last month's issue of this publication ("How To Fix It," March 1, 2008) attracted more reaction than usual. Like several previous issues, it was featured in John Mauldin's *Outside the Box* and Kate Welling's *welling@weeden*, and was also widely circulated on the Internet and elsewhere. While many readers agreed that drastic steps are needed to avoid continuing down the dangerous path that our economy and society are on, there were a few individuals who felt that *HCM*'s proposals were too radical.[1] But in the face of the wholly inadequate plan that Treasury Secretary Hank Paulson offered up in response to the current crisis, it is painfully apparent that our suggestions were not radical enough. Mr. Paulson's recommendations do little to address the regulatory black holes that permitted some of the most powerful institutions in the world to make hundreds of billions of dollars of worthless loans.[2] Moreover, his plan fails to address the asymmetric compensation structures that allow financial industry executives to leverage their firms to the hilt and then walk away with pots of gold before their institutions all too predictably tumble into the abyss, inflicting damage on all parts of the financial system except the executives' own wallets.

Despite the fact that the financial markets have temporarily recovered their equilibrium, virtually none of the profound imbalances that led to the current crisis are being addressed. The markets, and those with the power to regulate them, continue to cling to the false ideologies that

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[1] Most readers who disagreed with our approach took the high road, with the exception of one smug fund-of-funds executive who quoted a dead Nazi while accusing me of being a liberal fascist. He will no longer be receiving this publication from us. We are happy to listen to all types of criticism, however expressed, but we cannot stomach moral obliquity.

[2] Estimates of total losses from the credit crisis keep mounting. Morgan Stanley is beginning to think that its current estimates of $400 million of total losses from mortgage lending and $750 million of overall credit losses may be too low. See Morgan Stanley Research North America, *US Economics*, "Funding Pressures, Adverse Feedback Loops and Monetary Policy," April 14, 2008. Some are estimating that the losses will exceed $1 trillion. However you measure it, there aren't enough guillotines to chop off the heads of all of the responsible parties.

maintain that markets can correct themselves and that government regulation should be kept to a minimum. In fact, it has been the government that has had to bail out the markets each time they have nearly collapsed in recent years. George Soros makes this argument quite compellingly in a recent interview in *The New York Review of Books* ("The Financial Crisis: An Interview With George Soros," May 15, 2008).

> "[T]he system, as it currently operates, is built on false premises. Unfortunately, we have an idea of market fundamentalism, which is now the dominant ideology, holding that markets are self-correcting; and this is false because it's generally the intervention of the authorities that saves the markets when they get into trouble. Since 1980, we have had about five or six crises: the international banking crisis in 1982, the bankruptcy of Continental Illinois in 1984, and the failure of Long Term Capital Management in 1998, to name only three. Each time, it's the authorities that bail out the market, or organize companies to do so. So the regulators have precedents they should be aware of. But somehow this idea that markets tend to equilibrium and that deviations are random has gained acceptance and all of these fancy instruments for investment have been built on them."

This time, the authorities were not only forced to bail out Bear Stearns but were also compelled to take a series of unprecedented steps to infuse massive amounts of liquidity into the banking system in order to fend off a collapse. Some of these steps broke new legal ground. Former Federal Reserve Chairman Paul Volcker, who is enjoying a resurgence in idolatry for his tough love policies of the early 1980s, castigated[3] the current Federal Reserve for breaking new ground (and maybe the law): "The Federal Reserve has judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending in the process certain long embedded Central Banking principles and practices." *HCM* imagines that Mr. Bernanke's response, faced with a potential collapse of the credit system, would be, "So sue me!"

Over the past two decades, each successive crisis has required more draconian governmental action to ward off disaster because the global financial system has grown exponentially larger and more complex. This growth is largely attributable to the uncontrolled and unregulated growth of derivatives and other financial products that have never been truly stress-tested. This is what *HCM* meant when we wrote last month that "[i]n spite of claims to the contrary, the American economy has become increasingly unstable in recent decades." The only adjustment we would make to that statement would be to change the word "American" to "global" as the American economy has become increasingly linked to the global economy. The economic stability that former Federal Reserve Chairman Alan Greenspan used to brag about was just a veneer – under the surface, forces of instability were building due to the fact that the system was becoming increasingly leveraged and unregulated. That is why we have to fix the system before it is too late (if if is not already too late).

Mr. Soros points out in his interview, "[t]here are now, for example, complex forms of investment such as credit-default swaps that make it possible for investors to bet on the possibility that companies will default on repaying loans. Such bets on credit defaults now make up a $45 trillion market that is entirely unregulated. It amounts to more than five times the total of the US government bond market. The large potential risks of such investments are not being acknowledged." The CDS market, which is properly understood as an insurance market that is most likely under-reserved (not an insurance market without reserves, as some have incorrectly described it), now looms as everybody's candidate for the next accident waiting to happen. At the very least, it is somewhere between grossly and criminally irresponsible for the financial

[3] "Castigation" may sound like an overstatement but one has to understand Fedspeak to appreciate the harshness of Mr. Volcker's words.

authorities to permit such a vast market to remain unregulated. The real question is whether there is anybody in our government who is even remotely qualified to regulate this market. Even the slightest tinkering with a market of this breadth without a proper understanding of the potential consequences could add a frightening new chapter to the law of unintended consequences. Doing nothing, however, is no longer an option. The failure to make the regulation of this market the top priority of government regulators is nothing less than a national disgrace. Let us hope it does not turn into a national tragedy.

We wish we could be as optimistic as Morgan Stanley's highly respected economist Richard Berner, who writes: "Re-regulation and a safer, better-capitalized financial system are coming. Intermediaries with little to no regulation will get new oversight, new disclosure responsibilities, and new capital requirements."[4] Unfortunately, addressing the regulatory flaws that led to the current crisis won't be nearly as easy as Mr. Berner makes it sound. While *HCM* believes that more regulation is absolutely necessary, it is going to have to be implemented in a more enlightened and creative manner than in the past. The last time regulators took aggressive action to address flaws in the system, they badly missed the mark. They outlawed the type of off-balance sheet investments done by industrial companies such as Enron Corp. but completely ignored the much larger and more highly leveraged shadow banking system (the Structured Investment Vehicles (SIVs)) until it collapsed under its own weight five years later. Federal prosecutors engaged in a series of high profile show trials that featured far more abuses of prosecutorial power than findings of guilt against significant defendants. And the SEC stepped in too late, after billions of dollars were stolen from investors, to outlaw blatantly unethical but widely tolerated conduct such as lax underwriting standards verging on fraud, the participation of research analysts in the underwriting process, and after-hours trading in mutual funds. This time, we don't need political sound bites. We need independent parties with market experience who are not afraid to offend the powers-that-be to write and enforce the rules so our markets can function properly. Secretary Paulson is compromised, unfortunately, by his background as the former Chairman of Goldman Sachs Group, Inc. His reaction to the crisis appears to be far too protective of the industry in which he made his fortune and does not go far enough to address the issues of leverage and asymmetric compensation structures that are ruining our markets and destroying our economy. The need to change how our markets are regulated is not merely a matter of law or economics – it is a matter that will affect the future of our country as it moves forward into a globalized world characterized by commodity shortages, religious conflicts that have economic overtones, and increasingly rapid technological change. The financial markets lie at the center of our way of life, and our obligation to insure that they operate fairly and efficiently extends beyond mere economic considerations.

Nothing that has occurred in the past month dissuades *HCM* from the view that the long-term economic trends facing the United States are ominous and demand radical policy action. The continuing debasement of the U.S. dollar, the incessant (and only partially dollar-related) rise in the price of oil, and the unceasing flow of financial institution losses attributable to derivatives and structured products blunders convince *HCM* more than ever that the United States is set on a path that can only lead to a loss of its lead role in the global economy. The consequences of this will be deteriorating U.S. living standards on a relative and absolute basis, continued financial market volatility, further economic instability, and a long-term weakening of the United States' ability to influence world events in its favor. Americans, particularly the most advantaged, have sold their souls to the twin devils of immediate gratification and overconsumption. Unless we radically rethink our priorities and then put into action a drastic new policy regime, we will end up living in a world that is significantly more economically, culturally and spiritually impoverished than today's before the current century has reached its mid-point.

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[4] Morgan Stanley Research North America, *US Economics*, "Fixing the Credit Crunch – The Growing Case for 'Unconventional' Tools," March 25, 2008.

Long-Term Threats

HCM sees several long-term threats that are being ignored by the markets as they struggle for some type of short-term stability. While we see many opportunities to invest profitably in the near term, we remain extremely concerned about long-term economic trends. We realize, with sadness, that there are very few long-term investors left in the world. Investors seem to have taken to heart, in a manner that borders between irony and self-delusion, John Maynard Keynes' famous statement that "in the long run, we are all dead." Since we are all not going to be dead tomorrow, however, *HCM* thought it would be useful to discuss some of the trends that are working against us as we live out our days. At the very least, these factors should be taken into account by investors as they fashion investment strategies for short and intermediate-term time horizons.

Inflation: The first significant long-term threat is inflation – both asset inflation and product inflation. The steps taken by the Federal Reserve to rescue the U.S. financial system from collapse have created the conditions for a long-term inflationary boom. Simply put, the authorities did what they always do in the face of a threatened systemic collapse – they reflated like crazy. Providing the Federal Home Loan Banks and Freddie Mac and Fannie Mae to further swell their balance sheets with mortgage paper is hardly going to contribute to fiscal discipline. All it did was stick a finger in the dyke in the hope that other leaks wouldn't spring out right now.

Second, the demographic and political pressures lifting the prices of both soft and hard commodities remain unrelenting. Oil is just the tip of the iceberg, though the best analogy is one that places the U.S. economy as the *Titanic* sailing straight at it. The long-term energy picture is nothing less than ruinous for the United States and other oil-dependent Western economies as well as for the environment of our entire planet. The shift of wealth away from the U.S. and Western Europe toward countries that do not share our political values or interests is nothing less than potentially catastrophic for the future of world peace. That may sound like a terribly harsh statement to make now, but looking back on it in 50 years, it is likely to ring painfully prescient.

HCM's inflation view is somewhat different from that of Van R. Hoisington and Lacy H. Hunt of the highly regarded Van Hoisington Investment Management Company. We mention these gentlemen's views because their recent track record in economic forecasting has been second to none, and because we never believe we have cornered the market in knowing what's going to happen. In its most recent *Quarterly Review and Outlook*, Van Hoisington downplays the risks of a near-term inflation spiral. Conceding that CPI over the last twelve months has increased by 4.1 percent, much higher than the 2.8 percent average annual increase this decade, Van Hoisington points to four mitigating factors. First, inflation is a lagging rather than a leading indicator and believes that the historical pattern will persist of major reductions in inflation occurring in the early stages of the recovery from the current recession. Second, inflation gauges peaked well before the inception of the growth recession that began in mid-2007. Third, Van Hoisington believes that the upturn in headline inflation is transitory because higher food and fuel prices have not fed into wages (which is critical since labor costs comprise almost 70 percent of production costs in the U.S.). Finally, Van Hoisington believe that monetary policy is actually restrictive, not expansionary, pointing to the reversal of prior financial innovations (securitization) and absence of new ones, as well as the well-known refusal of banks to lend.

HCM would never dismiss the views of Van Hoisington, which remains among the most accurate inflation and economic forecasters around. One question *HCM* would ask Van Hoisington about its forecast is whether tightness outside the Federal Reserve system (i.e. the collapse of the shadow banking system – SIVs) will override the looseness being exercised by the Federal Reserve and other central banks themselves. In the near-term these two forces will

struggle, but in the long-term *HCM* expects that it will be hard for the Federal Reserve and U.S. Treasury to put the Jack back in the box. But on a broader level, *HCM* is looking out much further in time than Van Hoisington. Van Hoisington's view is not intended to be a long-term (i.e. 5-10 year view) of inflation (at least *HCM* does not read it that way). One cannot manage money very effectively these days based on such long-term views, although such forecasts should play some role in the process.

The almost exclusive focus on the short-term must be counted among the most profound flaws plaguing our markets and society today. And this is not merely a theoretical lament. This is one reason why so many investors end up losing years of returns in short periods of time through so-called "Black Swan" events. They invest in strategies that are sustainable in the short run, such as highly leveraged credit arbitrage strategies, but are susceptible to blowing up at some point in the future when conditions change in the future. Such changes in conditions are always a certainty; the question is the timing of such changes, and the ability of investment managers to exit positions before the Black Swan drops a turd on their heads.

Dollar Debauchment: The second threat to U.S. economic hegemony is the demise of the U.S. dollar standard. There is no way to avoid the conclusion that wrong-headed economic and political leadership have all but completely debauched the American currency. Jason Rotenberg noted recently in *Bridgewater Daily Observations*[5] that "we think we are now experiencing a breakdown in the US dollar system that is similar to the 1971 breakdown of the Bretton Woods system. Recent financial developments and the extreme provisions of liquidity that they have and will require are extremely bearish for the US dollar and are accelerating the process." *HCM* concurs with the view that the U.S. dollar breakdown is accelerating. With the Euro surpassing $1.60 for the first time (we take little long-term comfort in the recent "rally" to $1.55), the better play for investors concerned about the U.S. dollar continues to be South Asian currencies and the Chinese Yuan. But the fact that the dollar trades so poorly against the European currency, which represents an economic region that suffers from even more long-term structural deficiencies than the United States, raises serious concerns (however legitimate the view that the dollar is oversold in the short-term against the Euro).[6] *HCM* remains squarely in the camp of those who believe that the dollar is a terminal short play absent radical changes in economic policy in the U.S. and around the world.

Corporate Earnings Weakness: The third threat is slower U.S. economic growth than the rest of the world. This is a more complex question that deserves some discussion. Bridgewater Associates places the gap between U.S. and global GDP growth at 4 percent.[7] Dr. Marc Faber warns that corporate profits are going to be far weaker than Wall Street analysts are projecting. Dr. Faber writes: "[m]y impression from talking to a large number of investors and from attending numerous investment conferences is this: yes, the mood among institutional investors is negative due to recent losses, but the urge to buy the dips is still far greater than the urge to sell on rebounds. Institutions perceive the current credit problems to be temporary and still expect S&P earnings to recover strongly in late 2008 and 2009."[8]

Dr. Faber cites a March 17, 2008 research report by Morgan Stanley economist Richard Berner entitled "Downside Risk for Corporate Profits," in which Mr. Berner writes: "I think the earnings outlook will disappoint. The US economic outlook has darkened and fading operating leverage, dwindling pricing power, and deteriorating credit quality will squeeze margins. Despite the benefit of a weaker dollar, slower growth abroad seems likely to tame the overseas earning

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[5] *Bridgewater Daily Observations*, April 10, 2008.
[6] Just to be clear, at this point HCM would not recommend shorting the dollar against the Euro but would recommend shorting the dollar against a basket of South Asian currencies and the Chinese Yuan.
[7] *Bridgewater Daily Observations*, April 10, 2008.
[8] Dr. Marc Faber, *The Gloom, Boom & Doom Report*, April 5, 2008, p. 5.

boom."[9] Mr. Berner points to two areas of concern. First, the fact that operating leverage is currently far higher than in the 1990s, meaning that "a deeper recession, especially one that spreads abroad, would promote a much more serious profit squeeze." Second, overseas earnings represent 31.5 percent of earnings today, compared with only 15 percent twenty years ago, so a non-U.S. slowdown would bode poorly for U.S. corporate profits. Mr. Berner already sees signs of the U.S. slowdown impacting foreign earnings (particularly in Europe): "Together with tighter financial conditions, I'm concerned that weak earnings at European companies could contribute to a sharp deceleration in capital spending and in European growth. That would complete the circle, because it would also hurt US earnings abroad. About half of those overseas earnings originate in Europe." Morgan Stanley's European analysts recently projected a 16 percent drop in European corporate earnings this year, something that has not been carried through into U.S. analysts' earnings projections for U.S. companies with European exposure. U.S. stock market investors are still looking for a free lunch, and that lunch may be served cold (and stale). Weak corporate earnings are a particular concern in a recessionary environment in which the balance sheets of many companies have been larded with debt as a result of leveraged buyouts and similar speculative transactions. Retailers and airlines have already begun to default in packs, and more are of their brethren are certain to follow. Even as we appear to be well in the middle of the mortgage collapse, we are only in the very early innings of the corporate credit slowdown.

There is a counterargument to the weak corporate earnings thesis, however. Many U.S. companies are continuing to post extremely strong results, particularly in the capital goods, energy infrastructure, commodities and chemicals industries. Many U.S. companies retain unparalleled expertise in these industries and are exporting record amounts of products to the emerging markets around the world. One reason why the U.S. economy has not suffered as severely as some economists have expected from the housing industry collapse is that the global industrial economy has remained robust. *HCM* is working on a separate research report on the global industrial economy that explores this theme in detail, but our tentative conclusion is that many opportunities still exist to invest in the equity and debt of many U.S. companies providing goods and services to the global economy in the industries enumerated above. The question remains whether the strength in these sectors will be sufficient to counter the pronounced slowdown in the financial, housing and consumer sectors that will continue to hang as an albatross around the neck of corporate profitability in the U.S. and Europe in coming quarters. On a long-term basis, the outlook for growth in these segments, and for the U.S. companies selling into them, remains very bullish. We hope to have our report completed sometime in June and will be making it available to readers of *The HCM Market Letter* at that time.

Relief Rally

Risk assets rallied off their lows since JP Morgan Chase's acquisition of Bear Stearns in mid-March. The S&P 500 Index has jumped by 9 percent since that event, and the Merrill Lynch High Yield Bond Index has tightened sharply to a spread of 685 basis points over Treasuries from a high of 860 basis points. The prices of leveraged loans, which saw their worst drop in the history of that relatively new market in the first quarter of 2008, have also recovered sharply as dealers have managed to work down their backlog of unsold loans to under $100 billion from over $250 billion at year end. A key factor in the recovery in high yield bonds and bank loans has been the continued low level of defaults, which have increased but remain confined thus far to the airline and retail industries. In the meantime, financial institutions such as Citigroup have had little trouble attracting additional debt and equity capital and the markets are acting as though the worst of the crisis has passed. After all, compared to facing Armageddon, just waking up the next morning feels pretty good.

[9] Morgan Stanley Research North America, *US Economics*, March 17, 2008.

HCM is not surprised by this market recovery, particularly in the corporate credit markets. The bank loan market was bound to recover in the absence of any significant defaults since its sell-off was entirely technically driven. The high yield bond market, which remains a treacherous market for long-term investors, was also oversold in the absence of a rash of credit problems. At 680 basis points, however, it is again a poor value and should be avoided like the plague that it is (for everyone except the private equity firms who take advantage of its inability to price risk to purchase companies at exorbitant multiples). There is no question in *HCM*'s mind that default rates will increase significantly in the second half of 2008 and 2009. When that occurs, the worst losses will be experienced by the holders of high yield bonds in transactions that were completed in the 2005-2007 period, when acquisition multiples were mostly in the double digits. At anything less than 1000 basis points, high yield bonds do not compensate investors for the risks they bring in today's economic environment.

Bank loans, on the other hand, continue to offer excellent value even after their recent rally. As floating rate instruments that offer a senior position in the capital structure and collateral, bank loans offer extremely attractive risk-reward trade-offs. The market for Collateralized Loan Obligations (CLOs) remains moribund, but CLO liabilities remain an attractive way for investors to take advantage of the madness of crowds that have fled this asset class. Bank loans are not mortgages. One of the great lessons of the subprime debacle is that whatever fancy packages mortgages and other types of loans are wrapped up in, the only thing that matters in the end is whether borrowers can meet their obligations. Mortgage CDOs were flawed because the underlying borrowers couldn't make their mortgage payments, and all of the financial hocus-pocus in the world couldn't compensate for that. The same is true of CLOs. Either corporations will repay their loans or they won't. *HCM* believes that most will, and that most CLOs will end up repaying their liabilities and rewarding their equity investors handsomely. We are highly confident that those CLOs managed by our firm will do so.

The Road to Hell

As we said last month, the U.S. is being buried beneath the self-satisfied grins of investment bankers, hedge fund managers and private equity tycoons who have figured out how to make personal fortunes without contributing commensurate amounts to the productive capacity of our economy. We can only join in Jeremy Grantham's recent lament:

> "This has indeed not been our finest hour in the U.S. Times are bad enough, in fact, to make us mourn the American leadership skills of WWII and the generosity and foresight of the Marshall Plan. We can all wonder at the incredible vision, drive, organizational skill, and willingness to sacrifice resources that were required by the Manhattan Project and compare it to the rudderless or even deliberate avoidance of leadership of the greatest issues today: climate change and energy security. We can only wonder what a Manhattan Project aimed at alternative energy might have accomplished by now, had it been started 15 years ago. What we have had in lieu of vision, leadership, and backbone is a series of easy paths taken."[10]

It is a national tragedy that so much of the intellectual capital of this country is being directed at financial speculation rather than scientific and creative thinking. *HCM* believes that this is a problem of moral education. Our educational institutions need to teach the best and brightest students that there are rewards in this world other than pecuniary ones. Then it is up to the rest of society to insure that the financial rewards of doing good are commensurate with the benefits that such conduct confers on our communities.

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[10] GMO Quarterly Letter, April 2008, "Immoral Hazard."

PIMCO's Bill Gross is one of the few public figures in the market willing to speak out against the obscene compensation schemes that result from the asymmetric reward system that institutional investors have somehow been conned into believing align their interests with those responsible for generating the investment returns that will enable them to fund their future obligations. Jeremy Grantham's recent comments are consistent with our Mr. Gross's and our own views:

> "What's worse, those who took on unjustified risk live to prosper and reinforce the existing agency problems. These problems were big enough already: stock options, for example, that encouraged risks by rewarding upside success and punishing failure. If you win, you take some of the shareholders' company, and if you lose, you lose nothing. In fact, if you lose, you rewrite your options at depressed or crisis prices, just as some financial companies are doing as we write. Similarly some hedge funds and private equity firms can take a level of leverage that might guarantee failure in the long run but with asymmetrical returns they pocket gains and sidestep the worst impacts of a potential terminal loss. To maintain a healthy respect for risk taking, it is surely necessary to punish egregious over-reaching or spectacular misjudgment with the spectacular penalties they deserve and used to get but no longer."[11]

Despite the performance of the occasional outliers, pension funds, endowments and the like continue to experience shortfalls and other serious strains as professional money managers fail to provide sufficient returns to meet growing future spending needs. Moreover, outperformers continue to reap Brobdingnagian pay packages that sweep away a disproportionate amount of the upside from overall portfolio performance that never recycles back when conditions return to the mean. Some may think that we can simply continue on the road we are on. HCM believes otherwise. We believe that we must fix it.

New HCM Credit Funds

Hegemony Capital Management, LLC is launching two new credit funds that will focus on opportunities in the corporate credit markets (primarily bank loans on the long side and high yield bonds on the short side). Interested parties should contact Buddy Gengler at (561) 226-6199 or ggengler@hegcap.com.[12]

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[11] GMO Quarterly Letter, April 2008, "Immoral Hazard."

[12] This statement is provided for informational purposes only and is not intended as an offer to buy or sell, or the solicitation of an offer to purchase, any security or any other financial instrument. This statement contains preliminary information that is subject to change and that is not intended to be complete or constitute all of the information necessary to evaluate adequately the consequences of investing in the funds. An offer to sell an interest in the funds can only be made by the funds' offering documents, which should be read carefully by prospective investors prior to making any investment in the funds.

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