

The HCM Market Letter

Some Unconventional Views

“[T]here must surely be large profits to be gained from the other players in the long run by a skilled individual who, unperturbed by the prevailing pastime, continues to purchase investments on the best genuine long-term expectations he can frame...[T]here are ... such serious-minded individuals and ... it makes a vast difference to an investment market whether or not they predominate in their influence over the game-players. But we must also add that there are several factors which jeopardise the predominance of such individuals in modern investment markets. Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. It needs *more* intelligence to defeat the forces of time and our ignorance of the future than to beat the gun. Moreover, life is not long enough; - human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a higher rate. The game of professional investing is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll...Finally, it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short-run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”

John Maynard Keynes (1936)¹

It should be abundantly clear to the gatekeepers of capital that their investment thinking needs to be radically altered. Reliance on rating agencies, the reputations and advice of the world's largest financial institutions and money managers, government guarantees, quantitative financial models, and traditional measures of investment performance and value, has proved to be sorely misplaced. The world is confronting the frightening truth that the economic models, rules and standards that it depended on are no longer capable of managing a newly globalized and digitalized world of money. Twentieth century thinking is no longer adequate for twenty-first century markets. When you look at just a partial list of companies that are experiencing difficulties, it is obvious that a sea-change is taking place: General Motors; Ford; AIG; Citigroup, Inc.; Merrill Lynch & Co.; Lehman Brothers Holdings Inc.; Fannie Mae; Freddie Mac; UBS AG. Just a few years ago, these were the darlings of the business world. Today, there is a very real possibility that more than a few of these companies will not survive the decade.

It is becoming increasingly clear to *HCM* that the financial system is entering a new and prolonged phase of the credit crisis. The first phase lasted as long as financial institutions were able to raise capital from sovereign wealth funds and other sources to replace a significant

¹ John Maynard Keynes, The General Theory of Employment, Interest and Money (New York: Harcourt Brace & Company, 1964), pp. 156-58.

amount of the initial losses they were announcing. According to *Bloomberg News*, the world's 100 largest banks and securities firms have already tallied \$506.1 billion in asset write downs and losses during this credit crisis. Against these losses, these institutions have raised \$352.6 billion of new capital. That well has now run dry as holders of that \$352.6 billion of new bank paper are nursing huge losses and are reluctant to double down.² In the second phase, which is just beginning, such capital is no longer available due to the realization that the potential losses facing these institutions are much larger than originally envisioned. Moreover, during the initial phase, there was hope (based on nothing more than hope) that housing prices would stabilize and provide a bottom for the trillions of dollars of mortgage paper that Wall Street had vomited out into the coffers of the world's financial institutions. Instead, house prices have continued to drop, dragging down the paper stuffing the balance sheets of institutions around the world.

The second phase of the credit crisis will claim many victims. Some of these unfortunates will not be surprises (i.e. regional banks that fail); others will be more unexpected (i.e. one or more large financial institutions). Certain investment strategies will come under a great deal of pressure, particularly those that have been most highly regarded in recent years – private equity and distressed investing. In fact, institutional investors have yet to fall out of love with these two strategies despite abundant evidence that their risk-adjusted returns are far less attractive than advertised. In the coming 12 to 24 months, private equity investors are going to experience another dose of what it feels like to own vast amounts of illiquid, impossible to value paper. *HCM* can only shake its head when it hears about the valuations being placed by the private equity firms on their holdings in firms that are obviously insolvent. Do their investors really believe these valuations, or are they simply so conflicted that they happily accept them? It is hardly an accident that the largest private equity firms are now trying to reinvent themselves as bank loan investors. Private equity flourished because lenders were willing to lend money at uneconomically low rates. As a result, lenders drove themselves out of business (even before defaults began to rise). Without cheap sources of money, private equity firms have to find something else to do because they can't buy companies with 5 percent debt at 10x or 12x multiples of cash flow anymore.

Investors in distressed corporate debt funds are in for a rude awakening during the coming cycle. The leveraged transactions of the mid-2000s that will run into difficulty were completed at extremely high multiples of cash flow, leaving little room for error as the economy turns south. Moreover, the cost of the debt used to finance these transactions was absurdly low as a result of a global liquidity bubble. If these companies couldn't service such inexpensive debt, it is a sure sign that their balance sheets were grossly overleveraged and their business plans flawed. As a result, outside of the senior debt in most of the troubled companies distressed funds will target, there is going to be very little value left over for subordinated debt holders and equity holders (i.e. private equity firms).

Moreover, most LBOs were financed with securities that leave private equity firms holding all of the cards and debt holders limited means of protecting their interests. The proliferation of financial concoctions such as covenant-lite loans and PIK-toggle notes (bonds that give the borrower the option of paying interest in cash or in additional notes) allow private equity firms to defer defaults until all of the value in a company has been wiped out. Private equity firms have learned in previous cycles that the equity positions they hold in troubled firms can be worth a great deal of money, and they will not walk away from these investments until they are certain there is nothing left worth fighting about.

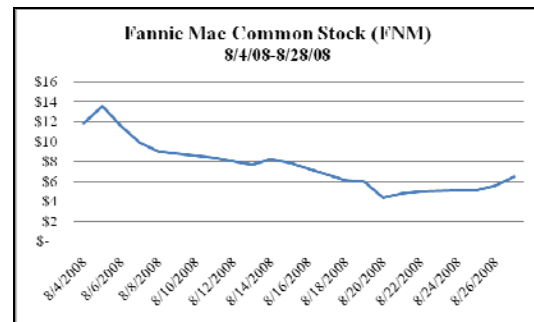
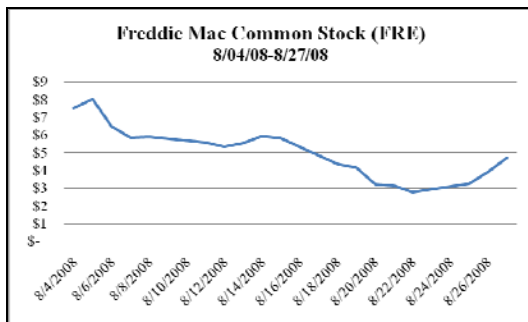
School is still out on what will happen to the funds being raised to invest in distressed mortgages. Mortgages are not corporate securities – they do not represent living, breathing organisms that are capable of coming back to life through the hard work of employees and

² Bloomberg's list does not include insurance companies (i.e. AIG International Group) and Fannie Mae and Freddie Mac, among other institutions that have suffered massive losses.

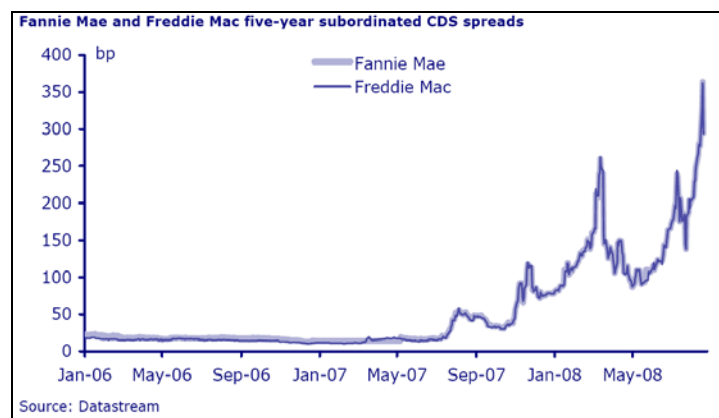
interactions with other economic agents. Mortgages are wholly dependent on the efforts of a single homeowner and are bound by the neighborhood in which they are located and do not have the ability to recover in value the way corporate securities do. It is entirely possible that certain investors will make killings buying distressed mortgage paper, but it is a completely different investment discipline than traditional distressed debt investing. Moreover, the amount of troubled mortgage paper dwarfs the amount of opportunistic capital that has been raised to invest in this area, a phenomenon that alone is likely to suppress recovery values and returns from this activity.

Fannie and Freddie: A Rose By Any Other Name

All eyes are on Fannie Mae and Freddie Mac. Actually, all eyes are watching these agencies' securities prices fade into oblivion as the markets try to anticipate the consequences of a federal bailout of the mortgage giants. The follow stock graphs show the sharp drop in Fannie's and Freddie's stock prices in the wake of a *Barron's* article describing a likely federal takeover of the two companies (although they have experienced a rally this week for reasons that *HCM* believes are completely unfounded):



The next chart, borrowed from Christopher Wood's *GREED & fear*, shows the spike in credit default swap (CDS) spreads (i.e. insurance protection) on Fannie and Freddie debt in recent months. The cost of insuring these agencies' debt has risen to levels that have effectively raised their cost of capital to the point where they can't possibly operate at a profit without the express guarantee of the U.S. government. The implicit guarantee that has supported them in the past is no longer sufficient to sustain these entities as going concerns now that the markets have woken up to the fact that they are functionally insolvent.



Some observers and market commentators are hoping that Fannie and Freddie will be able to refinance the more than \$200 billion of debt coming due in the coming weeks. The question may not be *whether* this debt can be financed but *at what price*. On August 25, Freddie Mac sold \$1

billion of three-month notes at a yield of 2.58 percent, a spread of 90 basis points over Treasuries, up sharply from a spread of 61 basis points over Treasuries a week earlier. The company sold six-month debt the same day at a cost of 12 basis points more than a week earlier. *HCM* expects Freddie's and Fannie's financing costs to bounce around until there is more clarity on what the end game will be for these two institutions.

As *HCM* has stated previously, the American taxpayer is now the de facto shareholder of both of these companies. It is the American taxpayer that bears the risk of further losses on their \$5.2 trillion mortgage book. Accordingly, it is time to bring to an end the sham of private sector ownership. Unfortunately, the situation is not as simple as that. Whatever the ultimate fate of Fannie and Freddie, the financial fallout is likely to be enormous.

There are at least two enormous and potentially systemically-threatening problems looming in a potential bailout of the mortgage agencies. The first is the effect of a bailout on preferred stockholders, which include many of the nation's regional banks. A federal takeover would ordinarily result in a wipeout of Freddie's and Fannie's common and preferred stockholders. Unfortunately, many regional banks count themselves as preferred stockholders of the agencies and count their Freddie and Fannie preferred stock as essential capital. An erasure of the value of this preferred stock could cause a rash of regional banks to violate their minimum capital ratios and be seized by the federal government. *HCM* believes that one factor that has delayed a full federal seizure of the agencies has been the necessity of determining how much collateral damage is going to be caused to the banking system and what can be done to limit it. This situation is yet another illustration of how interconnected the different parts of the financial system have become. More importantly, it demonstrates how widely the mortgage virus has seeped into every corner of the financial system and why it is going to take far longer to purge it than the happy faces on television or trying to raise money to invest in it are telling investors.

The second problem lies in the trillions of dollars of derivative contracts that have been written on Fannie's and Freddie's \$19 billion of subordinated debt. According to Gretchen Morgenson of *The New York Times*, \$62 trillion of insurance (i.e. credit default swaps or similar derivative contracts) have been written on these bonds.³ At the end of 2007, only \$2 trillion of this insurance was at "fair value," which basically means that only about 3 percent of these contracts were accurately marked to market by their holders. Markets are wrestling with the very real possibility that a federal bailout will not protect the subordinated debt holders of these entities, resulting in a "credit event" under the derivative contracts on their debt that could trigger the payout of untold amounts of credit insurance. If such a "credit event" were triggered, it is highly uncertain whether the writers of this credit insurance would be capable of making good on their obligations. This is one reason that the credit default swap spreads on Fannie and Freddie debt have widened so significant in recent weeks. In the case of the agencies' CDS contracts, however, the picture is somewhat murky. According to market sources, the agencies may be able to suspend interest payments on their subordinated debt for as long as five years without triggering a "credit event" under their CDS contracts. If this indeed the case, the Treasury will undoubtedly attempt to take advantage of this loophole to avoid triggering the payment of credit insurance on these obligations.

But the story doesn't end there. *HCM* would caution those who think that such a maneuver would provide an escape route for the financial markets. A delay in payment of interest on Freddie's and Fannie's subordinated debt of even one year, not to mention five years, would still significantly impair the mark-to-market value of the subordinated debt and CDS obligations related thereto. CDS contracts are highly leveraged to many things, not the least of which is the present value of the stream of cash flows (i.e. interest payments) payable under the

³ It is unclear whether Ms. Morgenson is referring to the amount of CDS written on Fannie's and Freddie's subordinated debt or all of its debt (i.e. its subordinated and senior debt), but frankly at the figures she is throwing around it doesn't matter.

underlying debt instrument. If those cash flows are delayed for a period of time, the market is going to severely discount their value. Accordingly, while the parties who wrote credit insurance may not be compelled to come up with the cash immediately to honor these contracts (cash many of them do not have in the volumes we are talking about), they are still going to see their balance sheets severely damaged by mark-to-market increases in the value of their future obligations to make good on these credit insurance obligations. In other words, there is no free lunch. In this case, deferring the problem may not eliminate the systemic risk at all.

At the current time, the potential Freddie and Fannie CDS liability and the ability to pay it may be (i) huge and unhedged, or (ii) huge and hedged, or (iii) unhedged but manageable. What we do know with a high degree of certainty is this – the market for credit insurance is huge and unregulated, so the odds of there being no problem at all are probably pretty small. At the very least, this is one additional factor that is likely delaying the end game for these two mortgage giants. The Treasury is going to have to examine this issue very thoroughly before it makes a move to nationalize these institutions.

There But For the Grace of God Go I...

As regulators continue to investigate the circumstances surrounding the collapse of Bear Stearns, other investment banks have taken matters into their own hands to insure that they will not suffer a similar fate. The *Financial Times* reported on August 18, 2008 (“Morgan Stanley updates lending systems”) that Morgan Stanley and Goldman Sachs have begun to tie their own lending commitments to hedge funds to the cost of their own debt. While these arrangements were in place before the demise of the Bear, they have taken on a new urgency in light of that event. According to the article, Morgan Stanley will reduce its lending commitments to hedge funds if the cost of credit default swap protection on its own debt rises to a certain level. The *Financial Times* pointed out that this move indicates the extent to which the derivatives market has supplanted the rating agencies as the final arbiter of a firm’s creditworthiness. This may indeed be the case (why anybody pays heed to the credit agencies anymore remains a complete mystery to *HCM*), although undue dependence on the derivatives markets may not always be the best way to gauge a firm’s prospects. In cases where a firm’s credit default swaps trade more actively than its bonds, the derivatives market may be a better measure of a firm’s creditworthiness, but in other cases where its bonds trade more actively than the derivatives, the opposite may be the case. Particularly in the case of financial firms whose health is often the subject of speculation and unfounded rumor, reliance on credit default swap levels can be dangerous and even systemically destabilizing (at was in the case of Bear Stearns). But there is something else at work in what Morgan Stanley is doing. By tying its willingness to lend to hedge funds to its own credit default swap levels, Morgan Stanley is effectively – and ingeniously - limiting the ability of hedge funds to short Morgan Stanley’s credit. Bear Stearns’ fallen leaders probably wish they had thought of this first.

Some Observations on the Leveraged Loan Market⁴

HCM would like to “talk its book” (or at least a part of it) for a moment. The topic is the leveraged bank loan market, in which *HCM* has been an active investor for over fifteen years. We currently manage two closed end bank loan vehicles that are performing extremely well in this difficult environment. We are also in the process of raising two open-ended funds that invest in bank loans. For the first time, pension funds and other institutional investors that have not previously invested in bank loans are considering doing so for the first time. Unfortunately, they are proceeding under a number of misconceptions.

On August 27, 2008, the *Financial Times* reported that “[p]ension funds are starting to wade into the market for loans to fund buy-outs and riskier borrowers, seeing opportunities to

⁴ Please refer to the Disclosure Appendix on page 9 when reading the following.

pick up investment bargains.”⁵ Ron Schmitz, the Oregon Investment Council’s Chief Investment Officer, stated in the article that, “[b]ank loans were a nice, stable, quiet market that didn’t offer any particular bang for your buck. Now, for a variety of reasons, it does.” Mr. Schmitz is correct. The bank loan market was hit by a perfect storm in 2007 that inalterably changed its characteristics as an asset class. First, the LCDX index was introduced in May 2007; instead of simply improving transparency and facilitating loan trading, this index became a volatility engine used by investment banks, hedge funds and other parties to either hedge their lending commitments or speculate on the direction of the market. This introduced significant price volatility to the market for the first time. Second, more than half of the demand for bank loans over the past few years came from the shadow banking system consisting of off-balance sheet Structured Investment Vehicles (SIVs) that were funding themselves with short term commercial paper to finance the long-term illiquid liabilities of Collateralized Loan Obligations (which own bank loans). When the SIVs came crashing down in mid-2007, demand for bank loans vaporized, sending the market for these loans into a tailspin. Third, about \$25 billion of mark-to-market CLOs were forced into liquidations or restructurings as a result of the sharp drop in bank loan prices that began in mid-2007, resulting in wholesale liquidations of loans. Finally, the withdrawal of credit by prime brokers from many of their hedge fund clients during the latter half of 2007 placed further pressure on hedge funds to reduce their bank loan holdings, leaving the market with more sellers than buyers. As a result of these events, the average price of leveraged loans dropped by more than ten points to below 90 percent of par, and a market that had once seemed an oasis of calm in the fixed income markets suddenly became turbulent and dangerous, particularly for the many highly leveraged investors it had attracted.

But there are other reasons why the bank loan market has suddenly become attractive to institutional investors. And these reasons are traps, not opportunities. Barbara Novick, a Vice Chairman at BlackRock, one of the large bank loan managers for whom *HCM* has a great deal of respect, states in the August 27th *Financial Times* article that the bank loan market “is opportunistic. It’s not a traditional asset class.” The truth is that the traditional first lien market should always have been attractive to institutional investors based on the fact that it produced consistent positive returns with low volatility and low correlation with other asset classes, even in difficult market environments. Today, that same first lien market remains attractive. The broader bank loan market that now seems to be attracting the interest of pension funds and private equity firms, however, is just a byproduct of the same credit bubble that caused the subprime mortgage meltdown. Institutional investors who are unaware of the significant gradations among different kinds of bank loans are likely to stumble in their attempts to uncover the next great investment opportunity in this market.

The burgeoning excitement about the bank loan market results from the fact that this market contracted the germ of insanity that infected all credit markets in the aftermath of the 2001-2002 credit market crash. A global liquidity boom fueled by record low interest rates allowed highly leveraged companies with low credit ratings to borrow senior debt at effective rates as low as 5 percent. This was an opportunity that was too good to be true for experienced private equity players, who began buying up any company in sight at double-digit multiples of cash flow. At the same time, Wall Street revved up the CLO machine to purchase these loans. A tsunami of global liquidity financed these CLOs at absurdly low spreads (i.e. AAA paper was sold at spreads as low as Libor + 23 basis points) and an enormous cycle of liquidity was created around the world. (This mirrored, by the way, the mortgage bubble that was inflating simultaneously.) This unprecedented credit bubble came crashing down in 2007, and now some investors are scrambling to pick up some gems out of the wreckage. Private equity firms, no longer able to finance new LBOs at 5 percent of any percent and sitting on many over-leveraged, troubled investments, are approaching institutional investors seeking to raise money to purchase distressed bank loans in their own deals (or the loans of their “competitors” – what’s the difference?). This is a strategy filled with a number of flaws.

⁵ *Financial Times*, August 27, 2007, “Pension funds seek deals in leveraged loan arena,” p. B1.

First, *HCM* would question how LBO firms' purchasing each others' distressed loans differs from these firms buying and selling companies to each other. That was a giant shell game, and this isn't much different. This is another type of speculative investment activity that does nothing except potentially help the investment banks lighten up their own balance sheets in exchange for promises of future business. The reason LBO firms are able to obtain financing to purchase these loans is because banks and investment banks are desperate to get these loans off their balance sheets and are prepared to lend 75 percent of the purchase price of these already discounted loans to their best clients. Now everybody is holding their noses and praying.

Second, allowing private equity firms to invest in this market is simply letting the fox into the chicken coop. You could not create more grossly conflicted investors if you wanted to (despite these firms' protestations about their Chinese Walls and other procedures designed to keep them on the straight and narrow). Private equity investors are in a position to buy these loans with an eye to ultimately purchasing the equity of the borrowers, which puts them in a direct conflict of interest with other debt investors. As Yale University's highly respected Chief Investment Officer, David Swensen, wrote several years ago, "the stewards of corporate assets pursue self-interest at the expense of providers of debt and equity capital. Bonds exhibit the most extreme misalignment of interests, as most debt issuers benefit by reducing the value of debt obligations, resulting in direct conflict between the goal of borrowers and lenders."⁶ This kind of activity just furthers a corruption of interests in the markets that leads investors to lose confidence in the ability of markets to fairly adjudicate disputes and protect the interests of stakeholders.

Third, most of the LBO loans that private equity firms are purchasing are unattractive investments. Over the past five years, bank loans crowded out high yield bonds as the primary source of capital for highly leveraged change-of-control LBOs. These loans were issued in grossly leveraged transactions done to effect changes in control for the sole purpose of speculation, i.e., to do a deal for the purpose of doing a deal, not for the purpose of building a company or adding to the capital stock or productive capacity of the economy. Private equity firms are incentivized and compensated to do deals, particularly when the raw materials on which they build their businesses – money – is being given away for free. The kinds of loans that are being offloaded onto private equity firms are in many cases precisely the kinds of deals that were only capable of being done because of the availability of cheap debt financing and the willingness of lenders to extend credit without asking for the types of covenant protections that are necessary to reasonably protect their interests. These are not the kind of loans *HCM* would purchase for its funds.

Fourth, the traditional bank loan market was infiltrated over the last few years by imposters that called themselves "loans" but are nothing of the kind. These financial instruments, called "second lien loans" and "covenant-lite loans" and other such monstrosities, are nothing more than junk bonds in disguise. And junk bonds, as we should all know by now, are nothing more than "equities in disguise" or "equities with a coupon," which means that they need to offer investors an equity rate of return, which none of these securities do. *HCM* will leave it to others to purchase second liens and other types of trash that were manufactured by Wall Street to feed the insatiable appetites of yield hogs and other investors who don't have the good sense to say no.

Institutional investors should be very clear that investments in broad swaths of the bank loan market will increase their equity exposure. Some funds appear to be aware of this and are using these investments in their equity allocation baskets. Others, however, may believe that bank loans do not correlate with other asset classes. The reality is that traditional first lien loans with strong covenants should not correlate with equities, high yield bonds and other risk assets. But investments in big baskets of LBO loans are just another way of investing in private equity.

⁶ David F. Swensen, Pioneering Portfolio Management: An Unconventional Approach to Institutional Management (New York: Free Press, 2000), p. 156.

Unfortunately, many of these loans are associated with transactions that were done at late stages of the credit cycle at inordinately high multiples of cash flow. Whatever profits may or may not be realized on these bank loans will at best serve to make up for the losses these same funds will experience on their equity investments in LBOs done at the same time. The fact that the bank loans are trading so far below par is an indication of just how under water the equity in these LBO investments are.

So where is the opportunity in bank loans? There is still a healthy first lien bank loan market that has been battered in price but not in credit quality by the problems in the rest of the market. There remain many large capitalization, first lien borrowers whose loans were not issued for the purpose of effecting a change of control transaction for a private equity firm, but to build plants and equipment as part of the global capital boom occurring primarily outside the United States. This sector of the market today offers the best opportunities to earn attractive risk-adjusted returns. This is the sector of the market in which *HCM*'s funds are investing profitably.

Investors, including those who are supposedly the largest and most sophisticated among us, will continue to make ill-advised investments as long as there are markets. It is time for the gatekeepers of capital to enlighten themselves about the conflicts of interest they are funding and the types of speculative deal making they are financing with their constituents' and clients' funds. But enlightening themselves is not enough. They need to start investing with an understanding that their own beneficiaries are not being served by investments that ultimately damage the system. This returns *HCM* to a topic that we have raised before – the idea that the current view of a fiduciary's obligations is deeply flawed. American fiduciary culture has instilled a belief that the primary obligation of a capital allocator is to generate the highest returns for its clients, plain and simple. This extremely narrow view of fiduciary obligations has empowered investors to ignore many other considerations that ultimately affect an investment's consequences for society and the economy. The negative fallout from this approach is all around us. The U.S. economy is dominated by speculation rather than production. Our environment is being destroyed before our very eyes. Our education system is geared to producing the wrong kinds of skills. These are all deep consequences of an economic system that privileges the raw rate of return over the quality-adjusted and risk-adjusted rate of return. Isn't it time that fiduciaries ask if the beneficiaries they serve are really benefitting from investments that are leading to job losses or environmental damage or, on a broader scale, equity market or credit market bubbles that inflict enormous damage on the American economy? Is it too much to ask them to look ahead beyond the next year or two of returns to the longer lasting consequences of funding speculative finance?

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Disclosure Appendix

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