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INSIDE

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By Michael E. Lewitt

Contain Complexity

The First Thing We Do, Let's Kill All The Quants

"No matter how much we believe in our institutions and in the regularized procedures of our societies, no matter how just, rational, and durable we think them, they are at best only loosely grounded on some form of bedrock reality or immutable truths that endure beyond human beings. To a considerable degree, they are sustained by collective belief and consensus, by tacit, unquestioned, and often grossly simplistic assumptions about how the world works, and often by mutual and willful self-delusion. Our societies cohere and function in no small part because most of us want them to cohere and function, and because the alternatives are, for the most part, literally unthinkable."

Thomas Homer-Dixon¹

A straight line connects the oil spill in the Gulf of Mexico to the near-1000 point plunge in the stock market on May 6th. Both events – one flesh-and-blood tragedy, one accident averted – were the result of growing complacency in our ability to manage an increasingly complex world.²

In 2000, Thomas Homer-Dixon, a professor at the University of Toronto, published a truly original and brilliant book entitled The Ingenuity Gap, in which he argued that "the complexity, unpredictability, and pace of events in our world, and the severity of global environmental stress, are soaring." Professor Homer-Dixon went on to argue that "[i]f our societies are to manage their affairs and improve their well-being they will need more ingenuity – that is, more ideas for solving their technical and social problems. But societies, whether rich or

poor, can't always supply the ingenuity they need at the right time and places. As a result, some face an ingenuity gap: a shortfall between their rapidly rising need for ingenuity and their inadequate supply."³ Drilling for oil more than 5,000 feet below sea-level is a perfect example of our reach exceeding our grasp. Doing so without taking steps to address the worst-case scenario that is now washing up on the beaches of the Gulf Coast is not only tragic but inexcusable.

We didn't start out drilling for oil in such deep waters. It is *HCM's* understanding that there are a limited number of deep sea rigs operating in the world today, and that the technology involved is highly complex. As Professor Homer-Dixon describes it, deep sea drilling, like so many other activities in our world, crept up on us incrementally. "The past century's countless incremental changes in our societies around the planet," he writes, "in our technologies and our interactions with our surrounding natural environments, have accumulated to create a qualitatively different world. Because these changes have accumulated slowly, it's often hard for us to recognize how profound and sweeping they've been...In combination, these changes have sharply increased the density, intensity, and pace of our interactions with each other; they have greatly increased the burden we place on our natural environment; and they have helped shift power from national and international institutions to individuals and subgroups."⁴ As a result, "the complexity and speed of operation of today's vital economic, social, and ecological systems exceed the human brain's grasp."⁵ The fact that neither

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the government nor the private sector was prepared for the blowout of the British Petroleum rig indicates a profound failure of planning, execution and regulation. While Congress and others look for individual causes and scapegoats, the truth is that this was a systemic failure with profound consequences for America's economy and energy policy. But it is also another indication of broader flaws in how we manage our affairs and think about complex problems.

The oil spill in the Gulf of Mexico is tragic in too many ways to count. It reminds us of the costs of incompetently managing our affairs, the high costs of America's reliance on fossil fuels, and the risks of assuming that technology can solve all of our problems. Professor Homer-Dixon writes: "Seduced by our extraordinary technological prowess, many of us come to believe that external reality - the reality outside our constructed world - is unimportant and needs little attention because, if we ever have to, we can manage any problem that might arise there. And, in any case, as the pace of our lives accelerates, we have less time to reflect on these broader circumstances. All these trends can push us into narcissism, as they weaken our sense of awe at the universe beyond our human ego; and what is perhaps most important, they also weaken our receptivity to critical signals from the external reality that might awaken us to our deep ignorance of the potential consequences of our actions, and warn us against hubris."⁶ When we can only see an actual drill-site via closed-circuit television and only physically access it through deep-sea robots and submarines due to its extreme depth, we tend to lose our sense of its reality - its pressure and freezing temperatures, the impossibility of its physicality. This leads us to let our guard down, to become less prudent in an endeavor that requires the highest degree of vigilance at every moment. The result is an environmental disaster that will haunt us for decades, not only with its physical and economic damages but with the knowledge that the accident was entirely avoidable.

The Imminent Failure of Financial Reform
What is even more alarming about the oil rig disaster is that we are about to demonstrate our inability to learn from our mistakes by repeating them in the arena of financial reform, where current legislative proposals continue to rely on the ability of both technology and regu-

lators to deal with increasingly complex products and systems. In order to understand why this is the case, we need to make a slight detour to discuss another important book.

Nassim Taleb has just published the second edition of his classic book, The Black Swan. What we loved about The Black Swan when we first read it (and we acknowledge that our reading may be a bit idiosyncratic) was its identification of a truth about the human condition - the fact that each human being's life is disproportionately impacted by a limited number of events, virtually all of which are unseen (and most of which involve the people we meet and end up spending our lives with as colleagues or mates). Moreover, these events can trump factors such as genetics and birth. What we came to love about the book as it became a huge public success was how it came to be misunderstood by most of its readers, who came to call many events Black Swans that were nothing of the kind.

In an extended postscript essay included in this new edition, Mr. Taleb addresses the 2008 financial crisis in the following way: "I will only very briefly discuss the crisis of 2008 (which took place after the publication of the book, and which was a lot of things, but not a Black Swan, only the result of fragility in systems built upon ignorance - and denial - of the notion of Black Swans. You know with near certainty that a plane flown by an incompetent pilot with eventually crash)...[Moreover] since there is nothing new about the crisis of 2008, we will not learn from it and we will make the same mistake in the future."⁷

As one of the few who predicted the 2008 financial crisis, *HCM* welcomes Mr. Taleb's words, which many will no doubt find surprising. But we also must express our intense frustration as we watch so many market participants (i.e. investors, the media) try to explain away the crisis as an unforeseen event when it was so obvious that the economic and market trends of the mid-2000s were unsustainable. As Professor Homer-Dixon writes: "The experts and elites at the apex of modern capitalism have a practically boundless capacity for after-the-fact rationalization. As soon as evidence allows, they paper over any cracks that have developed in their worldview. They rush to backfill the voids of doubt."⁸ The post hoc rationalizations are so frustrating because

investors and the media continue to give managers and strategists who missed the obvious (and lost billions in the process) the benefit of the doubt by continuing to entrust them with intellectual authority and money (perhaps because they too missed the obvious). *HCM* can at least take comfort in the fact that readers of this publication didn't miss the obvious, although whether they acted on what they learned in these pages is quite another matter.

There is no doubt in *HCM*'s mind that Mr. Taleb is correct – it will happen again. “It” is a severe financial crisis that threatens the stability and viability of the financial system. The reason such an event is inevitable is that inadequate steps are being taken by policymakers to introduce the necessary confinement mechanisms into the financial system to prevent a crisis from spreading and threatening the viability of large financial institutions and sovereigns. Mr. Taleb writes that “the idea is not to correct mistakes and eliminate randomness from social and economic life through monetary policy, subsidies, and so on. *The idea is simply to let human mistakes and miscalculations remain confined*, and to prevent their spreading through the system, as Mother Nature does.”⁹ We are not going to change human nature (even with the creation of artificial life, which is proceeding apace).¹⁰ Regulators are not going to suddenly become competent, and legislators are not going to start placing principal above political expediency and personal interest. In order to prevent contagions from spreading, however, the system must eliminate the germs that cause them. Those germs are born in leverage and speculation.¹¹ We cannot eliminate mistakes and randomness from the markets, as Mr. Taleb reminds us, but that doesn't excuse us from the responsibility to create safeguards that can limit the ramifications of such inevitable dislocations.

The financial reform legislation currently being debated in Congress unfortunately fails to eliminate the conditions and products that exacerbate systemic risk. In particular, the failure to ban (or place any meaningful limits on) naked credit default swaps leaves the financial system vulnerable to another contagion because these instruments connect all significant financial institutions into a single web that can only be as strong as its weakest link. As a result, the failure of one institution could unleash a series of failures among other institutional counterpart-

ties similar to the string of failures that occurred when Lehman Brothers filed for bankruptcy in September 2008. The unique characteristics of credit default swaps render them particularly noxious instruments whose use for pure speculation is uniquely destabilizing to the financial system. These contracts create incentives for their holders to see companies fail, and to accelerate the timetable on which the fail; this is inimical to economic growth and capital development (and is even disruptive to the concept of creative destruction enunciated by Joseph Schumpeter that so many believe is a healthy attribute of capitalist development and progress). The legislative proposals being debated require these instruments to be traded on exchanges and only modestly increase the capital required to trade them, but these requirements will do little to reduce the systemic risks they pose because they still leave in place their ability to link financial institutions together into one large leveraged web. As a result, the failure to ban naked credit default swaps renders much of the remaining financial reform legislation irrelevant in terms of preventing future financial crises.

But perhaps the most disappointing aspect of the entire financial reform debate is its elision of the broader issue that is steadily sinking the American economy into an uncompetitive position: the promulgation of a regime of rules and regulations that favor speculation over productive investment. These rules include tax laws that favor debt over equity, accounting rules that privilege obscurity over transparency, and industrial policy that fails to create the proper incentives for productive economic growth. Just as healthcare reform did little more than increase healthcare costs without improving the quality of care, financial reform is shaping up to be another empty legislative victory because it treats the symptoms without curing the underlying disease of misplaced incentives and misbegotten fiscal, monetary and regulatory policies.

Moreover, as the legislative effort engages in a great deal of sound and fury that will end up signifying nothing, the institutional investment community continues to follow the conventional thinking that has led it to terminally underperform and produce disappointing returns on its capital. Concepts such as volatility, risk, diversification, benchmarks, and returns remain fundamentally misunderstood and mis-

interpreted by the vast majority of institutional gatekeepers who continue to rely on the false mantras of efficient markets and investor rationality. In asset classes such as private equity, returns remain unadjusted for factors such as leverage, concentration risk, fees and illiquidity while institutions sit and wonder how their funds remain trapped in vehicles that lack both transparency and liquidity. The bottom line that institutions need to understand is that they remain grossly overexposed to the Ponzi-like structure of the global economy. The fulfillment of too many financial promises is reliant on the repayment of debts that require high rates of economic growth for which the prospects can only generously be described as dubious. Accordingly, institutions need to adjust both their return expectations and their strategies for achieving those returns instead of clinging to specious assumptions and flawed strategies that are only digging deeper holes from which they can never dig out. The failures of both the public and private sectors to understand the realities of markets and the true nature of capital grow costlier every day.

Killing the Quants

With apologies to William Shakespeare, who suggested we do to the lawyers what *HCM* is suggesting we do to the quants, as well as to our friend **Doug Kass**, who has already suggested killing the quants,¹² it is abundantly clear that quantitative traders have been allowed to assume control of the financial markets to an extent that is injurious to capitalism and economic growth.

In the April 2008 issue of this publication, entitled “How To Fix It”, that upset so many entrenched interests on Wall Street, some of my harshest criticism was reserved for quantitative investment strategies. I wrote the following more than two years ago:

“Quantitative Strategies: Quantitative investing has not only introduced an unhealthy amount of volatility into the markets, but has contributed to a larger trend in the financial markets that divorces the investment process from the concept of fundamental value. *HCM* would defy the quants to explain in any degree of detail what the companies in their portfolios do. This is another type of investing activity, like private equity, that does little or nothing to provide capital to increase the productive capacity or physical

stock of the economy. In fact, quantitative investment strategies are the quintessential “hot money.” Enslaved by their computer models, they trade in and out of positions at the blink of an eye. When things go wrong, they blame everybody but themselves. Being a quant means never having to say you’re sorry.

At some point, society has to figure out that the way an investor earns his money is even more important than the amount of money he makes. This is why human beings were vested with moral sentiments, so they could distinguish the quality of human conduct from the quantity of its results. Until that happens, we will continue to extol the types of investment activity that contribute little to our world. *HCM* would respectfully propose that a new school of “ethical investing” be adopted that takes into account how particular kinds of investments contribute to the economy. On this basis, quantitative strategies would be eliminated from consideration.”

The increasing amounts of intellectual and financial capital devoted to speculative rather than productive activities are slowly but steadily squeezing the life out of the American economy. In the financial markets, this phenomenon is manifested by the increasingly dominant role played by quantitative trading, which is largely comprised of computer-directed algorithmic trading strategies that, when stripped of their mathematical and technological paraphernalia, are little more than momentum-based trading strategies. They are another example of the deconstruction of all types of financial instruments – stocks, bonds, loans, mortgages – into 1s and 0s, which obliterates the underlying fundamental character of the human relationships that give rise to economic value. Quantitative traders have no interest in what a company does because their trading strategies are based on the technical trading attributes of the securities rather than the fundamental business attributes of the companies those securities represent. This is antithetical to capital formation because it diverts enormous amounts of capital into activities that have nothing to do with directing capital to businesses based on their productive contribution to the economy.

Quantitative trading activity also, as Doug Kass and others have pointed out, significantly increases market volatility, which is also an enemy of capital formation. The most radical

example of quantitative trading is “dark pools” that have sprung up around the world like black holes throughout the galaxy. *HCM* has been critical of “dark pools” in the past, describing them in the August 2009 issue of this publication (“At the Risk of Repeating Ourselves”) as “private playgrounds that hedge funds and investment houses use to trade in secret.” It is particularly inexplicable that regulators permitted “dark pools” for stocks to flourish at the same time that they insisted that corporate bond trades be rendered more transparent through the creation of the TRACE system, which requires all broker dealers to report all trades in publicly listed bonds within 15 minutes of execution. While *HCM* recognizes that consistency is the hobgoblin of little minds, allowing stocks to be traded in secret while requiring bonds to be traded in the open is nonsensical.

Paul Wilmott, a highly respected figure in the quantitative investing world, has also been critical of these secret trading exchanges, writing: “Thus the problem with the sudden explosion of high-frequency trading is that it may increasingly destabilize the market. Hedge funds won’t necessarily care whether the increased volatility causes stocks to rise or fall, as long as they can get in and out quickly with a profit. But the rest of the economy will care.”¹³ “Dark pools” are antithetical to the transparency that breeds confidence in financial markets. The fact that regulators are unable to explain the 1000 point drop in the Dow Jones Industrial Average that occurred within a 15-minute time span on May 6 is evidence enough of the need to disinfect the markets with the sunlight of transparency (and in this case is probably not another example of regulators’ terminal incompetence, although we can never rule that out). “Dark pools” only benefit those who are trying to conceal their trading activity from the eyes of regulators and other traders. Fortunately, regulators have been fairly aggressive in proposing strict volume and other limitations on these exchanges, although *HCM*’s understanding is that these have not yet been imposed formally. “Dark pools” are terrible public policy and should be banned, and *HCM* would be happy to debate this point with anybody who is prepared to take the opposite side of the argument.

What Are The Markets Telling Us?

HCM has been expecting U.S. equity and credit markets to continue to rally throughout the rest

of 2010 and into 2011 before succumbing to the dead weight of debt that is drowning government balance sheets around the world. The markets have definitively told us that we were wrong and that a sell-off couldn’t wait. Nonetheless, the downward action of the markets is giving short shrift to the pronounced improvement in certain indicia of economic growth and corporate profits. In particular, the S&P 500 is now trading at what would seem to be an extremely attractive valuation of less than 15x 2010 estimated earnings, and earnings are trending upwards. In addition, lower interest rates, mortgage rates and oil prices should contribute to economic growth. While the stock market is supposed to discount the future, stock market investors (particularly in the era of the quants) have become increasingly short-term oriented. Accordingly, it is odd that the market has been selling off on longer-term concerns. Odd, that is, until one understands just how serious those long-term problems are shaping up to be.

If the American economy is compared to a set of corporate financial statements, there are three things to look at: the income statement, the balance sheet, and the statement of cash flows. It is hard to make a case that any one of these is improving. In fact, all three would make a banana republic look good in comparison (especially if one watched C-Span for more than a few minutes to see how our republic is governed). The income statement is generating vast amounts of red ink – something on the order of negative \$1.5 trillion in fiscal 2010. The balance sheet is showing a growing debt burden that is close to reaching \$20 trillion when so-called off-balance sheet obligations (the hopelessly underwater Fannie Mae and Freddie Mac) are included. And the cash flow statement is showing far more cash going out than going in, on the order of trillions of dollars (even Social Security is now a use and not a source of cash). In short, the public sector finances of the world’s largest economy are deteriorating before our eyes.

Contrast that with improving private sector finances. Corporate America has done a yeoman’s job reducing debt (outside the realm of companies under the control of the private equity industry). Balance sheets are healthier, earnings and even revenues are improving, and the job picture is stabilizing. Unfortunately, a significant amount of the economy remains in

the hands of private equity, whose debt burdens continue to place a stranglehold on economic growth. Healthier private sector balance sheets bode well for the performance of corporate credit over the coming months despite the recent sell-off in high yield bonds. At the risk of sticking our neck out and getting it chopped off, *HCM* continues to expect the economy to show growth in the 2.5 to 3 percent range for the rest of the year and the stock market to be higher at the end of the year than it is today (1100 on the S&P 500).

The Credit Markets

The corporate credit markets have been in rapid retreat all month, with spreads on high yield bonds widening by more than 150 basis points to more than 700 basis points over 10-year Treasuries. This has led to sharp mark-to-market losses in a market that is currently experiencing very few defaults. The good news is that the market is again starting to properly price risk, and that higher spreads and interest rates will cut off the spigot for speculative private equity deals such as dividend deals and sales of portfolio companies by one buyout shop to another. These types of transactions allow private equity firms to conceal their mistakes and continue to con institutional investors into thinking that they are somehow creating value and providing attractive returns when they are doing nothing of the sort.

The so-called mega-buyouts, which deserve the same fate as the dinosaurs, are struggling under the enormous debts that were employed by their so-called “smart money” investors to grossly overpay for companies that had no strategic reason to go private in the first place. The typical large buyout today sits with debt equal to 10 or more times EBITDA (earnings before interest, taxes, depreciation and amortization). It is amortizing little debt, but is also unlikely to default due to the relatively low cost of its debt (rising Libor could change this for companies with high amounts of floating rate bank debt) and flexible covenants. Accordingly, these companies will be able to bump along for several years barring an economic collapse. However, the equity invested in most of these companies is currently worthless, which is not what the private equity firms are telling their investors. More aggressive private equity firms, such as Apollo Management, L.P., have been buyers of the discounted debt in these deals, realizing that the only way to salvage their equi-

ty investment is to shift value from the bond investors who were foolish enough to fund these deals at inception. What does all of this add to the productive capacity of the U.S. economy? Zilch. But it lines the pockets of the private equity partners at the expense of the institutions that entrust them with their money.

The Carried Interest Tax RIP

While the private equity industry tries to dig out from its mistakes, it continues to argue that it deserves special tax treatment for its contribution to the American economy. This is, not to put too fine a point on it, nonsense. The current debate about the private equity carried interest tax is so frustrating because it is filled with so much dishonesty about the true nature of the private equity business. There are certainly some activities, such as venture capital, that create jobs and add to the productive capacity of the economy. Such activities may deserve favorable tax treatment such as the lower tax rate on carried interests, which effectively tax labor as capital. But such is not the case for private equity. Private equity is a drag on the economy, not a boost. It does not create jobs, or fund research and development, or finance production. All it does today is replace equity with debt on the balance sheets of corporations while lining the pockets of its general partners with undeserved fees.

Private equity’s idea of innovation is to load companies with too much debt and, if they can pay some of that debt down, quickly reload the balance sheet with more debt to pay dividends to their sponsors. The buyout firms then crown themselves “financial engineers” and lord over the financial markets because their investment bankers and lawyers and paid-for politicians and lobbyists don’t have the courage to tell them that they are drowning the economy with too much debt and draining money from their investors and employees. There is no intellectual or policy justification for taxing the income of such activities at a lower rate than we tax other economic activities. In fact, in a rational world we would penalize such economically unproductive activities by imposing higher taxes on them. The carried interest tax for private equity is bad public policy and Congress must finally stop giving incentives to economic activities that cause economic harm. At the same time, Congress should make sure that the legislation does not remove incentives for legitimate productive investment strategies such as

venture capital, which create new businesses and products.

The Shrinking Superpower

One of the reasons that the markets have sold off in recent weeks is a clear concern that the financial system is still highly unstable and vulnerable to collapse. Whispers about Greece, Portugal and Spain did not have to travel far to morph into concerns about the finances of the United Kingdom and United States, both of which are on clearly unsustainable fiscal paths. But there may be other forces working to legitimately undermine the belief that the governments on which the world used to rely to enforce global stability are still up to the job (and not just their inability to manage markets or stop oil spills). Case in point is the failure of the world's powers to rein in the nuclear ambitions of Iran. This failure, which can only be described as both abject and ominous, was crystallized in the photograph of the president of Brazil, America's largest Latin American ally, and the prime minister of Turkey, the Muslim anchor of NATO, flanking and holding hands with the anti-Semitic thug Mahmoud Ahmadinehad (whose 2009 re-election to the Iranian presidency was clearly illegitimate) as they announced a so-called deal regarding Iran's nuclear capabilities that side-stepped American efforts.

As the journalist **Charles Krauthammer** has noted, this photograph stands as an appalling verdict on the diminished status of the United States in the world. It is damning evidence of how rising powers feel they can appease rogue nations that have publicly declared themselves America's enemies without fearing American anger. While the Obama administration tried to put the best face on this tripartite agreement among two of its most important allies and Iran, this was a humiliating blow (although the liberal press for the most part ignored it). Brazil's involvement in this disgraceful action is particularly ominous in view of the United States' passivity in the face of Hugo Chavez's deepening commercial and military ties with Russia, Iran and China. As Chavez's socialist policies further trash the Venezuelan economy and destabilize that nation, Venezuela's ties with Iran are a direct provocation to the United States. The Obama administration, however, appears to be asleep at the switch in Latin America, which will prove to be a very dangerous proposition if it does not wake up. *HCM*

expected much better of a foreign policy team led by Hilary Clinton.

Yahoo! Is *#^%'d

Those living in glass houses should be the last ones to throw stones, but *HCM* cannot resist raising the subject of the latest intemperate four-letter outburst aimed at Tech Crunch editor Michael Arrington at a New York symposium on May 25 by Yahoo! Inc.'s CEO **Carol Bartz**. Nor can we let the occasion pass without noting that Ms. Bartz, who appears to have an extremely high opinion of herself, was recently awarded a \$47 million compensation package despite the fact that Yahoo! continues to significantly underperform its peers and sink into increasing irrelevance in the Internet space. Since Ms. Bartz became CEO in January 2009, Yahoo! Stock has risen by only 16 percent compared with a 50 percent move in Google and a better than 40 percent move in the overall NASDAQ index. There is a good reason for this: Yahoo!'s performance continues to deteriorate as it becomes increasingly clear that Yahoo! is yesterday's news in a business where there are no yesterdays, only tomorrows.

The *Wall Street Journal* reported that in the year to April, unique U.S. visitors to Yahoo! rose by a mere 4 percent compared to 10 percent growth for the Internet overall, while page views fell by 13 percent compared with double digit gains for the Internet. It was also reported by *comScore* that Facebook passed Yahoo! in share of display-ad impressions (the number of times users saw an ad) in the first quarter of 2010. This poor performance occurred despite Yahoo!'s big marketing push. Yahoo! is trying to compete against Facebook and Google based on its belief that it has an advantage in offering content, but that is an illusion. The one thing that is available in abundance from multiple sources on the Internet is content (in fact, there is too much of it, not too little), and more content providers are entering the market each day. Yahoo! Is facing a losing battle and will continue to lose market share and importance.

So perhaps Ms. Bartz is trying to gain market share for her company by attracting users to YouTube to watch her curse out her critics. One can only wonder what the directors of her company are thinking after awarding her an egregious and obviously undeserved financial windfall and then seeing her embarrass herself and the company. After all, this is not the first time

Ms. Bartz has found herself unable to adequately express herself in the English language without resorting to words that are best left on the locker room floor. Being the head of a public company is a privilege, not a birthright or license to act out. The last CEO who wilted under the pressure by resorting to cursing out critics was Enron's Jeffrey Skilling (although we will leave the comparison at that). It is one thing for an overpaid and arrogant CEO to ignore her critics; it is quite another for her to

publicly curse them out. Coupled with the poor performance of the company, it suggests her that she is temperamentally and probably otherwise unfit for her job. Yahoo!'s directors need to start looking for somebody who can handle the job that their arrogant and intemperate CEO is failing to perform. Yahoo! stock is a short.

Footnotes:

¹ Thomas Homer-Dixon, *The Ingenuity Gap* (New York: Alfred A. Knopf, 2000), p. 150.

² As David Brooks wrote in *The New York Times* ("Drilling for Certainty," May 28, 2010, p. A19): "Over the past years, we have seen smart people at Fannie Mae, Lehman Brothers, NASA and the C.I.A. make similarly catastrophic risk assessments. As [Malcolm] Gladwell wrote in [a] 1996 essay, 'We have constructed a world in which the potential for high-tech catastrophe is embedded in the fabric of day-today life'....There must be ways to improve the choice architecture - to help people guard against risk creep, false security, groupthink, the good-news bias and all the rest....It's a challenge for people living in an imponderably complex technical society." Mr. Brooks probably gives too much credit to the alleged intelligence of the folks at Fannie Mae and Lehman Brothers, whose judgments were corrupted by motives other than intellect.

³ Homer-Dixon, 1. Italics in original.

The *HCM Market Letter* June 1, 2010

⁴ *Ibid.*, 3.

⁵ *Ibid.*, 4.

⁶ *Ibid.*, 83.

⁷ Nassim Nicholas Taleb, *The Black Swan: The Impact of The Highly Improbable* (New York: Random House, 2010), pp. 321-22. The same could be said of the Gulf oil spill - that it was not a Black Swan, not that we won't take steps to prevent future accidents - which was clearly foreseeable once the facts concerning operational and regulatory lapses on the rig are disclosed.

⁸ Homer-Dixon, 163.

⁹ Taleb, 322. Italics in original.

¹⁰ See J. Craig Venter and Daniel Gibson, "How We Created the First Synthetic Cell," *The Wall Street Journal*, May 26, 2010.

¹¹ Mr. Taleb repeatedly makes the point that eliminating or reducing leverage reduces the harm that Black Swan events can cause.

¹² Doug Kass, "Kill the Quants Redux," May 7, 2010.

Doug Kass is general partner of Seabreeze Partners and his essay was written for TheStreet.com.

¹³ Peter Wilmott, "Hurrying Into the Next Panic?" *The New York Times*, July 29, 2009.

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