

# THE EXCHANGE

The Quarterly Newsletter of the Portfolio Management Institute

## Editor's Quarterly Market Observation: Gold Bubble, or Inflation Trouble?

By Jeff Hugel

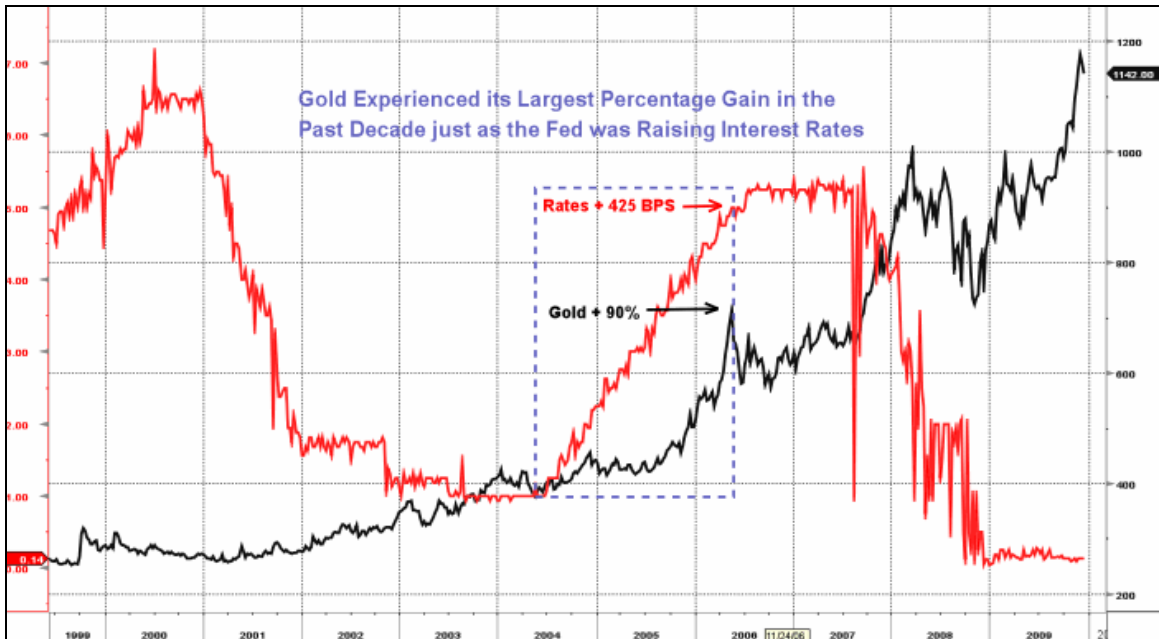


Figure 1 – Spot Gold (Weekly), Fed Funds Rate (Weekly); Source: Bloomberg Finance LP

In June 2004, then Federal Reserve Chairman Alan Greenspan initiated a credit tightening cycle that would take the Fed's overnight funds rate up by 425 bps from its 1% low before handing the reins to his predecessor, Ben Bernanke, 18-months later. Throughout that period, Fed officials were adamant in their public comments that the risks to growth were balanced between inflation and deflation. Yet, concomitant with the Fed's tightening cycle, the price of gold bullion experienced its largest 18-month percentage gain of the past decade, rallying some 90%. Conventional wisdom has it that the price of gold is "inversely correlated" to value of the U.S. dollar, and that the dollar's strength is tethered to short-term interest rate moves. By this logic, one could naturally conclude that the dollar should be strengthening during a tightening cycle, and conversely the price of gold should be in decline. Not so this time. But, why not? Even a cursory review of producer prices during the cycle would reveal that the YoY% change in the PPI more than doubled from a low of 3.3%, to a high of 6.9%. The likely culprit: artificially low interest rates. With talk abound of another credit tightening cycle ahead, investors concerned with the next directional move in the price of gold might want to pay attention to the YoY% change in the PPI. It bottomed in July at -6.8%, and as of October, has cut that deficit by 72%. With rates again artificially too low, I reckon that a repeat performance of the last tightening cycle could catch the conventional thinking consensus flatfooted once again when it comes to gold.

## From the Desk of the President

By Jerry Tepper, PMI President

As we conclude the final act of 2009 and the decade, we can reflect on what a ride it was. Certainly from an investor's point of view, the media labeled the last ten years as the lost decade. While we have clearly been witness to and participants in some of the most unsettling events ranging from market crashes to personal tragedy, all was not lost in my opinion. As Portfolio Managers, I believe each of us had the unique opportunity to reach out to clients during these turbulent times and to provide not only superior investment advice, but support and counsel as well. As discretionary money managers, our clients

have said to each of us, "I am in your hands." For those of us that have the skill and confidence, this was our chance to step forward and lead.

PMI has helped me to become a better PM. It continues to provide me with an ongoing flow of valuable information, acts as a source for advanced education, and keeps me in contact with my colleagues around the country. It has proven itself to be invaluable by offering me access to so many resources specifically focused on my role and responsibility as a PM. It is truly a one of a kind organization. I hope you view PMI in much the same way as I do.

Before we close out the year, I ask you to renew your membership. We are keeping our membership fees flat despite increasing costs. I also urge you to mark the dates for the Forum in Atlanta (April 21-23) on your calendar right now and to plan to attend what many believe is the best offsite meeting of the year. And keep in mind, all of this is BDP eligible.

Let me wish you and your families the happiest of holidays and for good luck and much success in the New Year.

All the best – Jerry

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## **BARBAROUS**

By Jared Dillian (Adapted from *The Daily Dirtnap* with permission)

Gold is in a bull market. That is an undisputable fact. The fact that there are so many people who will dispute that fact is more evidence that it is in a bull market.

Gold is the most important trade today, and it will be the most important trade over the next decade. Many people do not understand this. Believe me when I tell you that I have taken some serious abuse, even at the hands of my own clients, or friends of my clients, for my gold bullish views. Gold is trading quadruple digits and people still do not get the joke. They cannot get their arms around the fact that something that does not produce widgets, does not sell insurance, does not make little blue pills, does not pay a dividend, has no cash flows, and must be guarded by big guys with big guns can have any value in a civilized society. In a way, they are right. But they forget that we are no longer in a civilized society.

What does it mean to live in a civilized society? A civilized society is a government of laws, not men. A civilized society understands that government is not to be worshipped or deified, that it is simply plumbing, the pipes and wires that are hidden from view that keeps things running, essential services like law enforcement, corrections, the criminal justice system, and enforcement of private contracts. And most importantly, in a civilized society, the authorities do *everything they can* to ensure that the purchasing power of the currency is not eroded. They understand that to allow the currency to depreciate in real terms is to perpetuate a fraud on the people who attempt to store value with their savings.

We are no longer a civilized society.

This is why they call gold the "barbarous relic." You might think that barbarous refers to the Vikings that you see in the Capital One commercials with poleaxes, wearing furs. No, barbarous is a state of mind. It is a national character. And just because we don't have much crime, doesn't mean we're not barbarous. Barbarous means that people believe that another man should live his life not for his own sake, but for someone else. Barbarous means that people have embraced a tradition of sacrifice, that a human life is not meant to be enjoyed, but is a means to an end, to *someone else's end*. Barbarous means that, through inflation, a stealth form of redistribution, the value of your savings will be diminished and redistributed to someone else.

To understand gold is to not simply understand supply and demand. It is not enough to know how much is produced, and how much is consumed, and whether it is consumed for investment, industrial, or adornment purposes. These statistics can help, but they are not the whole story. To understand gold, to be a gold investor, you need to understand the philosophy that underlies gold. With stocks, with credit, and with most currencies, it is enough to be a bean counter, an analyst, a CFA, an accounting nerd. You don't need to understand (much) philosophy to buy a share of GOOG. But if you buy a share of GLD, you had better know what you are getting into.

What you are getting into is centuries, no, millennia, of monetary history and the history of currency debasement, back to the period of time when people used to cheat and shave off little slivers of gold off of coins. You need to understand that for *centuries*, price inflation was *negligible*, and it was only with the advent of the flexible monetary standard and the nonconvertibility of paper currency into gold that we began to have real inflation. And boy, have we ever had it. Prices have increased by at least a factor of four from when I was a child. How do you preserve wealth in such an environment?

It is not just about inflation. It never is. If it were, then TIPS would be in a raging bull market, and they're not. In a civilized society, private property rights are sacred. Your land is your land. Your house is your house. Your stock is your stock. Your senior claim to the cash flows of General Motors is not to be abrogated. Folks, we have been practicing barbarism over the last eight years.

Barbarism is bullying. More specifically, barbarism is raiding, looting, and pillaging. It means *to initiate the use of physical force* against someone else. Paper money, securities, and other cash flow instruments cannot survive in an environment where they are not safe, safe from physical force. But gold is a refuge from physical force; you can hold it, store it, hide it, or use it for bribes.

When church and state are not separated, you have inquisitions, executions, and the use of force. Separate church and state, and you have a free market in religion; religion thrives, there is choice, people attend services of their own free will. When church and state are together, church goes underground. There is a bull market in secret religious ceremonies. People live in fear, for their beliefs.

See what happens when you do not separate *economy* and state. People go underground; black markets develop to avoid price caps and floors, the proliferation of regulation turns every actor into a criminal. Gold is the response to an intertwining of economy and state. It is a rational response; it is the only way to store wealth and value. If economy and state were separated, *gold would not be necessary*.

The fact that it is trading where it is, tells us that it is necessary. It tells us that in this modern society, with its technology and its laws and its advanced cultural institutions, that we are no better than the Vikings. We are looters and pillagers. If we were not, then gold would be irrelevant. *And the very fact that so many people ask me about the confiscation of gold is a statement not just on our barbarism but the value of gold as an investment.*

This isn't so much a question about what the market tells us about gold as what gold tells us about the market. Gold is telling us that all these paper promises, the QE and the CE and the lending facilities are just that, paper promises, and there are consequences. Gold is the escape valve. Print money, gold goes up. Modify mortgages, gold goes up. Nationalize an auto manufacturer, gold goes up.

I have never been so bullish on anything in my entire life. Yes, gold, and GLD, had a horrific decline on payroll Friday. I do not ignore the technicals. The technicals are useful. The technicals are telling us that the last year will be one short chapter in a long bull market for gold, which can be expressed through GLD and call options on GLD (both of which I own-full disclosure), which I have mentioned before, are vastly underpriced.

But what do I know? I am just a banged-up former ETF trader with an axe to grind.

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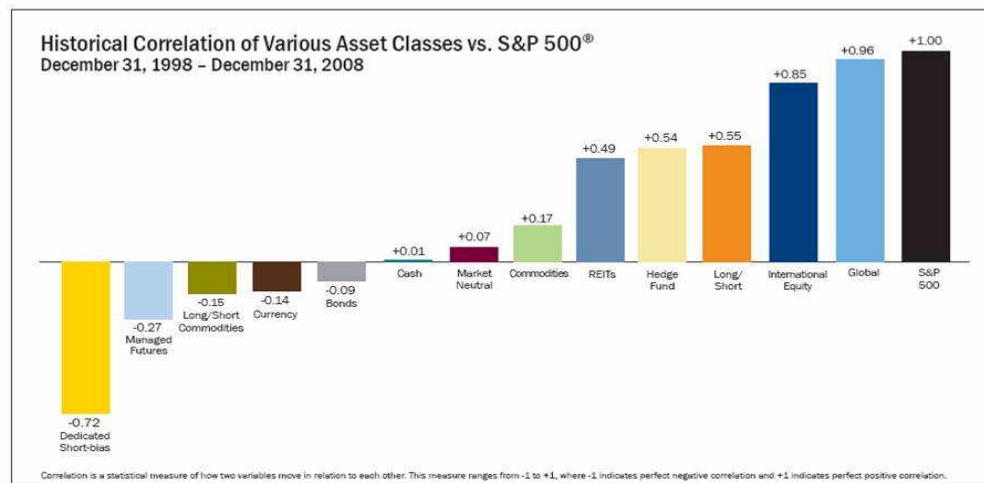
## **Imperfect Hedges for an Imperfect World**

By Adam Tzagournis

Many Portfolio Managers are concerned about the stability of the equity markets especially with last year's market meltdown still fresh in their minds. Traditionally, a manager has been able to either move into other asset classes (cash, bonds, commodities), or utilize direct hedging instruments in order to offset systematic or market risk. However, since the crisis began, certain asset classes that had traditionally moved in a non-correlated or negatively correlated manner with the stock

market have instead positively correlated. Additionally, certain Exchange Traded Funds (ETFs) that negatively correlate with equities have been prohibited in discretionary programs such as PM and Custom Portfolio. We will examine some of the techniques available to Portfolio Managers (PMs) who are concerned with market risk.

- Cash has been the traditional asset class of choice when concerns about market levels arise. Although those fortunate enough to carry high levels of cash leading into major market declines were able to experience better relative performance, recent declines were severe enough that absolute performance was still abysmal for most. So a mix of 33% cash and 67% S&P 500 resulted in negative returns in the mid-twenties. Cash is an important and useful tool, but inadequate when attempting to preserve and protect accounts in harsh environments.
- Treasury bonds have served as decent instruments in offsetting market risk in the past several years as indicated in by the chart below. One must perform his or her own due diligence when evaluating bonds as a good prospective counter weight in light of the Treasury Department’s current and future financing needs as well as the historically low yields offered by US Treasuries.
- Through ETFs, managers can gain access to foreign currencies and commodities in a way that is relatively inexpensive, transparent and usually liquid. Again referring to the chart below, a basket of foreign currencies has had some negative correlation to the market. When considering commodities, one must be cognizant of the fact that some commodities are economically sensitive and therefore may move in harmony with stocks during a decline. Gold has exhibited negative correlation to equities over time, but over the past couple of years has positively correlated.



**Source: Rydex Investments**

As cited earlier, the universe of direct hedging instruments available to PMs has shrunk, but there are still several vehicles worthy of consideration.

- Selling covered calls provides limited downside protection, only to the extent of the captured premium. Obviously the tradeoff is the concession of the stock’s upside beyond the strike price. This can be an effective strategy if a manager expects a flat to slightly lower stock price for the time period covered by the option contract.
- Buying protective puts is like buying insurance. This strategy will protect against larger declines in stocks since it allows the put buyer to sell the stock for a fixed price at a later date. This strategy comes at a cost since puts require paying premiums, which can be substantial. For that reason this strategy is best used tactically rather than as a continuous strategy.
- Going long volatility via the S&P 500 VIX Short or Intermediate-Term Futures ETNs, symbols VXX and VXZ respectively, allows a PM to effectively “cover” his short volatility exposure, an inherent quality of being long risk assets. This strategy is also best used tactically, and requires the use of “delta hedging” techniques to regularly adjust ones hedge ratio in order manage the effects of stochastic volatility.

- Long/Short and Dedicated Short mutual funds allow PMs to be short stocks or indexes without the potential risk of unlimited loss. We as PMs cannot control which securities will be shorted, but by doing our homework in advance and monitoring the funds we chose, we can reasonably judge as to whether our intent to hedge against the risks we perceive is adequately reflected. My team has screened the mutual funds available on our PM platform and has come up with the funds that contained a net short position in equities at the time I wrote this article. As always, do your own due diligence prior to investing in any of these funds. The available funds that are net short are: Federated Prudent Bear Fund (PBRIX), Comstock Capital Value Fund (DRCVX) and Leuthold Grizzly Short Fund (GRZZX).

There is no such thing as a perfect hedge; puts involve wasting time premiums and Dedicated Short mutual funds involve fund fees and expenses. The hedges which are not available to PMs have their own shortcomings; shorting stocks or future contracts involve unlimited loss potential, while OTC derivative products can be costly and involve liquidity and counterparty risks. Inverse ETFs involve timing and pattern risks as well as the risks associated with the derivatives used by the ETFs. Traditional non-correlated or negatively correlated assets can diverge for long periods of time from their normal comparative relationships. We as portfolio managers cannot analyze stocks or construct portfolios in a vacuum. We must carefully consider the condition of the macro-economic environment and consider risks that can impact the entire market and multiple asset classes, and then implement a strategy that best protects against the risks we perceive.

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## **Do Your Clients REALLY Know What You Do? The Power of Proper Positioning**

By Sarah Dale and Krista Sheets

Consistently articulating your true value proposition to prospects and clients will lead to increased client retention. One of the reasons why advisors may have lost clients over the last 18 months is that they failed to articulate their ENTIRE value proposition. You really can't blame clients for solely looking at bottom line performance when you haven't taken the time to let them know ALL the value you bring to the table on an ongoing basis. Take a moment to think about all the elements that you and your team provide for your clients; then consider how many of those elements are really articulated and demonstrated to each and every client. Advisors who have done a great job of sharing their entire story to prospects and clients have not suffered a loss of clientele during recent turbulent times.

When clients don't understand all of what you do for them, they will often undervalue your services. They may try to put you into a "box". It may be a "product box," such as "Oh, that's John; he's my insurance guy." Or it may be a "pricing box," such as, "That's Sally; she's my money manager." Your client's perception is reality, and any misperception makes the relationship tenuous at best. When tough times come (as they always will in this cyclical world we live in), you are risking being dispatched as their advisor. You do not want to be judged by a single number, factor, or quality because at some point you will lose the relationship. Rather, you want to be assessed by the totality of the value of your work and the relationship that you develop with your clientele. If you want to increase client retention, loyalty, and referrals, YOU have to take the time to ensure your clients really understand the full value that you offer to anyone who does business with you. If you haven't reviewed your value proposition for current relevance in the last year AND let all your clients know what it is, then you should!

### **5 Simple Questions Provide a Solid Foundation**

We suggest that you answer five simple questions to form the basis of your value proposition.

**Who are you?** There are many different types of financial professionals with different levels of expertise, experience, and knowledge. By clearly answering this simple question, you can educate clients on how your expertise fits into a very complicated and convoluted industry of titles and professional designations. Are you a generalist or a specialist, a financial planner, a broker, an insurance specialist, a wealth manager, an investment consultant, a financial advisor, etc. and what does that title mean? It is important to not only view this question from your individual perspective, but also from that of your team. You must get beyond your 'title' as it relates to this question. Put yourself in your clients' shoes and consider what these words mean to them. Who are you really?

**What do you do?** As you think through this question, consider all of your offerings, solutions, and services. Within the industry, we know that you do more than just put together an investment portfolio; but do your clients know what these additional components are? Whether you are a specialist or a generalist, there is certainly more than one element to your offerings and value. You should have an organized, systematized, and proactive service model as part of your business. Consider the ingredients of your service menu as you answer this question, in addition to the obvious products, solutions, and planning services that you provide for your clientele. And a more important question to answer can be – “What do you NOT do for clients?” Often advisors promote too varied offerings, which only leads to inefficiencies in the practice and bringing on the wrong clients who take you from your core business and end up not being profitable.

**Who do you do it for?** When answering this question, you want to consider your ideal client relationship definition. You may or may not have a very specific niche that you serve, but either way, every financial professional should be able to verbalize the type of clients you work with. This is important to your PRACTICE for efficiency, profitability, and enjoyment reasons; it is important for your CLIENTS so they can provide you with QUALIFIED referrals rather than people who may not fit your model. It is impossible to be successful at being all things to all people, so you need to define the value that you bring to your specific target audience.

**How do you do it?** With this fourth question, you should consider your process. Clients need to know how you do what you do. How do you put together the right selection of investments for them and how do you know when to make a change? They don't need to know the "nitty-gritty" because that is why they have you, their trusted advisor. However, when they are looking at the "cost" of your services, you want them to know it is an ongoing process, not a one-time event! Today, TIME is a most precious commodity for everyone; do your clients really know the time capacity you invest in taking care of their needs?

**What makes you different?** With this final question, you should consider your differentiator. You must be able to answer the question, "Why should I do business with you?" or "What do you offer that I couldn't get from Jo Smith at ABC Investments?" Today's industry is commoditized; the same products can be purchased from almost anywhere - they are just wrapped up in slightly different packaging! Typically, YOU, your TEAM, and your SERVICE are key differentiators, but you better be able to articulate HOW and WHY you are unique. We highly recommend using a service commitment agreement with both prospects and clients so you can begin to not only TELL them (words), but also SHOW them (actions) why they should do business with you! In our Know Service book, we include everything you need to create the agreement and position it properly to prospects and clients.

### **Cultivating Your Value Proposition**

As you embark on creating your value proposition, be sure to make it a team activity. You want all team members to tell a consistent story so that you all come across as a united front. Additionally, PEOPLE are your most important asset; they are a critical component of your value proposition. The more engaged they are in helping you create your 'story,' the more committed they become to demonstrating that value on a daily basis.

As you take the time to answer these questions and cultivate your value proposition, make sure that you and your team incorporate it into all areas of your business.

**Marketing Materials:** Adapt and update all your marketing materials and initiatives to reinforce the message:

- Story and elevator speech
- Team brochure
- Website
- Service commitment agreement(s)
- Other client communications as appropriate

**Commitment Meetings:** Establish commitment meetings with your existing clients to be sure they understand your entire proposition. This activity, by the way, nearly always leads to finding new business and attaining more depth or breadth to your product and service mix! Clients often have no idea how much you do as an advisor. This conversation will help you get out of the "product box" and into the holistic value model! The commitment meeting, held annually, also provides the opportunity to reset expectations, which are the very foundation of client retention!

**Prospecting Process:** Incorporate your new 'story' into your prospecting process; this will help you set expectations and have your value understood right from the onset of the relationship.

**Evolving Value:** Review these questions and your value proposition at least annually during your strategic planning sessions. So much can change in your business in one year and you want to ensure that you are always communicating any NEW value that you bring to your client base. For example, adding a new team member typically enhances your value proposition and

subsequent offerings to your clientele. Don't overlook professional designations or educational opportunities your team members achieve. Let clients know when you attend industry conferences that add to your ability to serve them. Clients need to know that you and your team are completely committed to excellence. Be sure to articulate changes or achievements to your clients.

### Converting Words into Actions

Creating your story and value proposition is step one; articulating it to your clients and prospects is step two. The most critical step, though, is to ensure that you DEMONSTRATE that value on a daily basis with each and every interaction. Remember, perception is reality. So, to stay out of the "box," whether product or price, and not be judged solely by a "performance number," your words about value must transcend into actions that create real value on a regular basis! Consistent execution to this end will lead to increased client retention even in the most turbulent of times!

*Sarah E. Dale, President & Founder  
Know No Bounds, LLC*

*Krista S. Sheets, President  
Paragon Resources, Inc.*

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## Sometimes the Best Offense is a Good Defense

By Jeff Hugel (Adapted from *HUGE INSIGHTS* – 12/4/09)

For the better part of 9-months, equity markets worldwide have rallied vociferously. During that period, small and mid-cap stocks in the U.S. have outpaced their large-cap brethren by more than 22 percentage points on average. But recently, several negative divergences have become apparent in the secondary indexes. At best, this raises valid questions about the sustainability of this relative performance gap, and at worst the durability of the rally itself. To me, the evidence is sufficient enough at this time to at least suggest that a rotation is underway in the U.S. markets out of high beta, low quality, small-cap stocks and into low beta, high quality, large-cap stocks.



**Figure 1 – XLG / RSP Ratio (Daily Close); Source: Bloomberg Finance LP**

Illustrated in *Figure 1* above, is the ratio of the Russell Top 50 Index ETF (XLG) and the S&P 500 Equal-Weight Index ETF (RSP). This relationship (XLG / RSP) represents outperformance by small and mid-cap U.S. equities vs. mega-cap U.S. equities when the ratio is declining, and outperformance by mega-caps vs. small and mid-caps when the ratio is rising. It is noteworthy to mention that ratios have very strong mean-reverting tendencies, but this does not preclude these relationships from reaching extremes under the right conditions. An example of such a condition was experienced last year following Lehman's bankruptcy, as capital flocked to the highest quality, most liquid securities in the U.S. market, causing the ratio to spike over a two month period to more than 3-standard deviations above its long-term mean; the ratio peaked on 11/20/08.

Since then, the relationship has substantially reversed this extreme, which by definition has favored significant outperformance by small & mid-cap stocks. Having bottomed in September, at 2-standard deviations below its mean, the ratio has since displayed convincing signs of a trend reversal in the opposite direction. As the evidence began to build in further support this conclusion, I began shifting the emphasis in our Global Asset Allocation Model portfolios away from small & mid-cap exposure via RSP, in favor of mega-cap exposure via XLG. While this tactical move has already yielded a positive performance spread, it could produce significantly greater long-term relative outperformance if this analysis proves correct.

Importantly, my work has now identified a small, but potentially meaningful reversal pattern developing in the ratio; what market technicians refer to as an inverted head & shoulders (H&S) formation. The annotation in the chart of a bold, horizontal dashed-line (blue) represents what would be considered overhead resistance, and a traditional H&S neckline. A breakout above this overhead resistance would confirm the pattern, generating an intermediate-term upside target of 2.30 for the ratio, or at minimum a retest of the bold, solid downtrend line (red). Such a move would translate into more than 500 bps of relative outperformance by mega-cap stocks over small & mid-caps. Longer-term, I would expect the ratio to mean-revert, and potentially extend this trend reversal toward 1-standard deviation above the mean, as has been common in the past.

U.S. Sector Rotation Model	Factor Weights	Energy	Materials	Industrials	Consumer Cyclicals	Consumer Staples	Health Care	Financial	Technology	Telecom	Utilities
Constituents		38	29	58	81	41	54	80	75	9	35
GROWTH	20%	1	-1	-1	1	-1	1	-1	1	-3	-3
VALUATION	40%	3	-4	1	1	2	0	0	-3	3	3
MOMENTUM	20%	3	-1	0	0	2	0	-1	2	1	1
RISK	20%	-3	-2	-4	-2	3	4	-4	4	0	0
Composite Score		4	-8	-4	0	6	5	-6	4	1	1
<b>Sector Ranking</b>		<b>4</b>	<b>10</b>	<b>8</b>	<b>7</b>	<b>1</b>	<b>2</b>	<b>9</b>	<b>3</b>	<b>6</b>	<b>5</b>

**Table 1 – U.S. Sector Rotation Model (as of 11/30/09)**

Of course, the style rotation into mega-caps described above reflects my subjective observations. However, these observations are confirmed by a recent analysis of twenty quantitative factors, which I utilize to rank the S&P 500 GICS sectors from best to worst (1 to 10), based upon the growth, valuation, momentum, and risk dynamics of each relative to the aggregate market. The results of this study are illustrated in *Table 1*. Corroborating the technical analysis above, the top four sectors by rank, Consumer Staples, Health Care, Technology, and Energy dominate 70% of the market cap of the Russell Top 50 Index, while Financials and Materials represent only 14%. Given the strength of the technical and quantitative evidence, I believe that investors are in the early stages of a shift from their prior offensive posture toward a more defensive posture going forward. As such, I recommend overweighting high quality, mega-cap U.S. equities with emphasis on the Consumer Staples, Health Care, Technology, and Energy sectors. For long-only investors seeking a single security solution, I recommend XLG. For hedge-oriented investors seeking a pair trade, I recommend going long XLG against a short sale of RSP to fully express the potential of the analysis discussed.

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*Portfolio Management Director*  
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## PM's Resource Corner

For investors who demand responsible journalism and timely content, there is no substitute for FT Alphaville, available for free at <http://ftalphaville.ft.com/>. This site regularly posts succinct, well-written articles by the FT's top financial journalists and thought leaders in the business world.

Attention PM's: <http://seekingalpha.com/> is the free on-line information swap meet for traders and investors seeking idea flow and answers. Need a quick answer as to why your favorite stock is down 7% when the market is up 2%? Want to know

what the best performing ETF is on a given day? Want to know what the biggest hedge funds are buying and why? If you can't find it at Seeking Alpha, you won't find it anywhere.

PM Rick Grimshaw recommends this sight: <http://www.scottgrannis.blogspot.com>. "I think this guy is one the best financial bloggers around," says Grimshaw.

Please forward your free resource recommendations to: [jeffrey.huge@citi.com](mailto:jeffrey.huge@citi.com)

## Cartoon Corner:



Cartoon – Courtesy of Matthew Diffee



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For PM's by PM's

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