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Unintended Consequences of the New Financial Reform Legislation on Public Pension Fund Returns

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The Goals of "Financial Reform"

- ✓ Reduce systemic economic and financial market risk (such as the complete freeze up of credit markets in the fall of 2008).
- ✓ Level the playing field between lenders and consumers.

- ✓ Reduce conflicts of interest between investment banks and clients.
- ✓ Increase disclosure to promote fairness.

- ✓ Punish those who "created" the financial excesses of the last economic cycle (like Rating Agencies).

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What's Cannot Be Fixed in Financial Markets with Current "Reform?"

- ✓ Instantaneous Delivery of Financial Information - Permanent
- ✓ Increasingly "Correlated Beliefs" that cause trend following behavior, valuation extremes and market volatility
- ✓ Eliminate the Shadow Banking System without permanently impairing the availability of credit, particularly to housing
- ✓ Outsmart financial innovators (both those that are beneficial and detrimental)
- ✓ Eliminate inherent conflicts of interest in financial transactions

Result – Financial market volatility will NOT go down.

Systemic economic risk could be reduced but at the expense of real GDP growth.

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Optimal Government Policies in Financial Crisis

1. **Fed Maintains a Steep Yield Curve and Encourage Equity Capital Additions – Done before passage of legislation**
2. **Reduce Counterparty Risk with Exchange-Traded Derivative Contracts & National Clearing House – Some positives contained in financial reform bill but incomplete.**
3. **Permit Mark to Market Based on PV of Expected Future Cash Flows – Done before passage of legislation**
4. **Lower Reserve Requirements and/or Lengthen the Timing of Implementation of Basel III Capital Ratio Requirements – Under consideration in international regulations**
5. **Lower Barriers to Entry to Capital for New Banks – Not done yet as Fed has focused on shoring up solvency of existing banks**

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Unintended Consequences of Reform

- ✓ Corporate and Municipal Bond Market issuance halted (temporarily) by creating liability for ratings issued
- ✓ Credit Card Interest Rates go up in response to new rules preventing raising rates on bad credit risk consumers
- ✓ 300+ regulatory rulings required to implement reform law creates confusion and delays economic decisions (i.e. by lenders to lend)
- ✓ Control over financial service pricing will result in fewer services and higher fees for other services
- ✓ Lending standards will remain tighter and required loan spreads higher as a result of reduced profitability of lenders

Result – Economic activity and growth will be retarded by financial reform, not encouraged by it. Risk is for Stagflation.

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Impact on Financial Market Returns from "Reform"

Increased Risk of Stagflation

5-Year Horizon

			Estimated Return Outlook	
	Real GDP	**Inflation**	**Stocks**	**T-Bonds**
Return of Inflation	4.5	4.5	Happy Days Are Here Again	*Really Ugly*
Stagflation	1.5	3.5	Modest to OK	Pretty Ugly
Historical Norm	2.5	2.5	Still Super	Still Ugly
Perfection	4.0	1.5	***Boom Time Again***	Not Much
Recession/ Deflation	-1.0	0.5	Double Dip Better Than 08	***Bond Heaven***

Outlook and returns are subject to change and should not be viewed as a promise of future performance.

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Impact on Financial Market Returns from Reform

- ✓ Stock market valuation is currently attractive, despite uncertainties in economic outlook.
- ✓ Corporate profits are still well below normal and rising rapidly.
- ✓ Corporate balance sheets are in great shape.
- ✓ Income tax policy more important than financial reform to outlook over the next two years.
- ✓ Interest rates are unsustainably low.
- ✓ Consumer deleveraging will continue to be a drag on consumer spending and financial reform legislation will NOT improve this.

Outlook NOT bad despite confusion and lack of clarity on changes in regulation