

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

Investment Advisors Presented by:

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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.

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- ✓ 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

- 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

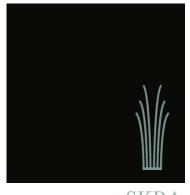


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## Unintended Consequences of Reform

- 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.



# Impact on Financial Market Returns from "Reform"

## Increased Risk of Stagflation

#### 5-Year Horizon

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			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