Agenda

• Big Picture
• Market cycles
  • Where we are heading now
  • Business cycle and other cycles
• Global economy
• Housing, subprime & financial market meltdown
• Market impacts
  • Treasury cash
  • Retirement funds
• Strategy issues
  • Cash, Debt & OPEB

Plus a bonus topic!
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(How to go home smarter than your Finance Director)
First, the Big Picture !!!

- Stagflation
- Domicile Deflation & Housing Hangover
- U.S. U-bottom
- Downbeat Dollar
- Global Growth
- Darwinian $$ Dynamics
- Unlisted Utopia
Market cycles

- Long-wave cycle
  - Yes, Kondratieff is back!
    - Inflation vs. deflation, raw materials, petroleum, land, populism vs conservatism, “certificates of confiscation”

- Extended business cycle
  - Now a services economy
    - No longer the 3.6-year industrial business cycle
    - More likely 8-10 years with 1 or 2 hiccups
      - Interest rate spike
      - Financial meltdown from market excesses

- 2008: Is this a replay of 1987 and 1998?
  - Or will the real estate recession drag us all down?
Global economic issues

• Pathetic, weakening dollar
  • Euro > $1.50 = payback for twin deficits in trade and fiscal policy, with entitlements only getting worse

• American and global inflation risks
  • IMF: 6.2% global inflation, 3.2% in developed countries
    ▪ Risk of monetary tightening overseas

• Oil and raw materials

• Booms in Asia and Latin America
  • Are they sustainable at 8% compound growth forever?
  • Brazil becomes a creditor !!!!!
Housing-Subprime-Financial Market Meltdown

- Real estate bubble
  - Same syndrome as biotech, dot.com and someday the oil bubble
  - Grossly overpriced, *unaffordable* properties
  - Ridiculous lending standards at post 9-11 rates
    - Greenspan Fed deserves some blame here

- Mortgage mess = Financial Mess

- And Shorts = Sharks, till the Fed stepped in
  - Lehman showed the way for future defenses
What’s next?

- Housing prices destined to fall further
  - Lower prices needed to clear many markets
  - Congressional action?
- At least one national homebuilder will likely bankrupt or be taken over
- Countrywide, WaMu, others on the ropes
  - Buyouts in financial services inevitable
    - For those with strong stomachs, study the preferred stocks
  - Strong get stronger; financial Darwinism (JPMorganChase)
- Fed funds depressed through 2008
Growth Slowdown and Correction -- or Real Recession?

- Double bottom in place in stock market at DJIA 11,600
- May Stimulus checks
  - Savings and credit card payoffs will later be spent
- Consumer still the key
  - Housing deflation would break consumers’ backs
- Overseas economies: Decoupled or linked?
  - Will China slow after the Olympics?
- Avg recessionary bear market = 25% down
  - DJIA 11,000 or S&P 1200
Market impacts - Treasury Debt

• Municipal bond spreads too wide/high
  • Muni market a mess
    • Bond insurance fiascos
    • Auction-rate muni markets freeze up
    • Muni bond funds weak
    • And CALIFORNIA budget deficit of $16 billion !!
      • Too much oncoming supply !!!

• MIPS? (municipal inflation protected securities)

• Full blown recession could open window finally for high-quality muni debt issues
  • Could then include OPEB bonds (more later)
  • Potential refundings then, not now
Market Impact – Treasury Investments

- ‘Cash is trash,’ as fed funds futures low and flat for a year out < 2%
- Inflation risk not compensated because of flight to quality
- Risk spreads remain wide
  - Unlikely to subside until storms pass
- Agencies: Freddie and Fannie
- Corporate paper: credit risks
- Derivatives – cat on a hot tin roof !!!
Market impact -- Derivatives

- Failed auctions for auction-rate munis
- VRDO turmoil
- Mismatched swaps will blow up hedges
- GASB hedge accounting tests
- Inflation-protected munis?
Market Impact: Retirement Portfolios

- Stocks have corrected sufficiently for a financial meltdown, but not a general recession
- 7th inning of extended cycle, or extra innings already?
- Muni bonds vs treasurys & corporates
- Mortgage paper revival by year-end?
- International equity still favored, but surprise snap-back dollar rally eventually
  - Corrections in overpriced Asian markets
Strategy: Treasury cash

- High quality: no choice due to headline risk

- Beware of recovery risk of higher rates
  - If the credit crisis fades and an end-cycle scenario plays out
Strategy: OPEB

- DB plan required for older workers
- Establish DC features for new and younger workers
- Cap benefits – hard or soft
- “Baby steps” budget technique: 1% a year
- Investment strategy:
  - For unfunded startup, consider all-equity portfolio given stock market correction level (or 85% equity)
    - Feature: Full equity market returns expectations of 10-11% will reduce unfunded liability
  - If recession takes market to DJIA 11000, sell OPEB bonds
OPEB trust funds

• Need to establish proper structure
• Investment authority
• Formal board
• Set up the trustees with majority of independent, non-beneficiaries
  • Inherent conflicts of interest already discovered in San Diego *Lexin* case
  • Remedies: Girard’s “mutual fund model” for independent directors vote on conflict-prone matters
• CalPERS is not your only choice:
  • Midwest pension fund is coming soon!
  • Low-fee index fund strategies with consultant assistance
Strategy: 457 investments

- Lower fees are attainable
- Bid out the plan administration
- Target date funds (pros and cons)
- Family of index funds
- Simpler menu – can customize
- Junk bonds now OK, reflecting credit risks
- Formally review “brokerage window” results
- Piggyback an OPEB DC plan for leverage
New World of Fund Balance

- GASB exposure draft
  - New display for “spendable” fund balances
    - Restricted (by law or contract)
    - Limited (by governing body action)
    - Assigned (by mgmt or board pursuant to gov body)
  - Rainy day/ Budget stabilization accounts

- Fund balance policy

- OPEB funding strategy
  - Annual operating surplus to OPEB trust

Bonus Topic: How to go home smarter than your Finance Director
Summary

- Stagflation and malaise
- Risks abound
- Caution in 2008 is well advised
- Dead money in capital markets
- OPEB is job #1 for smart treasurers
  - You should be the investment strategist for OPEB
- Become a fiscal wizard/ess of fund balance
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