♦MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION♦
BOARD OF RETIREMENT MEETING MINUTES
♦MAY 8, 2013 AT 8:30 A.M.♦

CALL TO ORDER

Shari Schapmire, Board Chair, called the meeting to order at 8:30 a.m.

ROLL CALL

Roll call was conducted with the following members present: Shari Schapmire, Lloyd Weer, Ted Stephens, Supervisor John McCowen, John Sakowicz, Richard Shoemaker, Bob Mirata, Tim Knudsen, and Randy Goodman. Members absent: Craig Walker. Also present: Rich White, Retirement Administrator, Jeff Berk, Legal Counsel, Judy Zeller, Board Clerk.

PUBLIC COMMENT: None

1) APPROVAL OF THE MINUTES OF THE BOARD MEETING HELD APRIL 17, 2013.
Upon motion by Supervisor McCowen, seconded by Mr. Weer; IT IS ORDERED that the minutes of the April 17, 2013 Board meeting are approved unanimously.

2) DISCUSSION REGARDING QUARTERLY PERFORMANCE REPORT (CALLAN ASSOCIATES)

Presenter/s: Greg DeForrest, Callan Associates, provided a detailed overview of the first quarter investment performance report for the Association stating that there was an excellent market for the 1st quarter. The Standard and Poor's (S&P) 500 was up 10.6% and the International market was up 5.13%. Emerging markets were down and Bond market income was low with a loss of 12 basis points. The fund is up 5.1% with a benchmark of 5.3% and five year total fund returns have been good at 5.25%.

Mr. Stephens and Mr. Shoemaker asked about the Kings Court Real Estate and how the returns were calculated in the performance report. Mr. DeForrest stated that this information is based on monthly income information provided by Association staff.

Our current Asset Allocation target was discussed and we are close to target. Callan is preparing a new asset allocation study for the Board to review in June. Mr. DeForrest mentioned that our new passive manager will be funded once the contract is complete and confirmed that Selected American and the Investment Company of America are the best choices for use as funding for the new investment. He then referred to information previously distributed to the Board titled Asset-Liability Allocation study phase I. This explained how the asset allocation study would be accomplished. Goals, market projections, and modeling with simulations to show potential outcome were discussed.

Mr. Stephens stated that there are more outgoing benefits than we have in investment earnings. Mr. DeForrest explained that the study will look at how much is withdrawn relative to the size of assets. Liquidity is an important issue to be considered and Capital Market expectations are the cornerstone of any strategic planning process. Projections are constructed with annual processes, cover most broad asset classes and inflation over 10 years, and incorporate quantitative modeling, qualitative inputs, and the expertise of the consultants at Callan.

Mr. Sakowicz asked about alternative investment. Mr. DeForrest replied that it can offer diversification with a different path of returns and added that in 2008 Hedge funds were down 20% when markets were down. Mr. Stephens asked about Bonds and interest rates going up. Mr. DeForrest agreed that a 2-2.5% increase in Bond market interest would be very bad.

Mr. Shoemaker asked about rate of return expectations, assumptions, and a difference in assumed inflation rate. Mr. DeForrest explained that Callan uses an assumed inflation rate of 2.5% over a period of 10 years which is very different from an Actuary using a rate of 3% over a period of 30 years.

Board Direction: Callan will include Hedge Funds in our Asset Allocation study with a 5% cap on the investment and will present to the Board at a future meeting.

BREAK

3) ANNUAL FIDUCIARY TRAINING AND DISCUSSION

Presenter/s: Jeff Berk, Legal Counsel, facilitated an annual fiduciary training for board members. This training was conducted in accordance with the MCERA Trustee Education and Travel Policy and all Board members participating received credit for 1 education hour. Discussion included Fiduciary duties and how to fulfill them. Plenary authority was explained and the Board's primary duty is to MCERA members and Beneficiaries.

4) DISCUSSION AND POSSIBLE ACTION REGARDING THE PROPOSED FISCAL YEAR 2013/14 BUDGET

Presenter/s: Rich White referenced information previously distributed to the Board regarding the proposed fiscal year 2013/14 budget. He stated that the Audit and Budget Committee met on April 30, 2013 to review the draft budget. They provided direction to staff regarding the accountant position, the administrative assistant position, and technology which was incorporated into the proposed budget. Mr. White mentioned the pertinent Government code sections 31580.2 and 31596.1 regarding administrative budget adoption for Board consideration before beginning discussion. The Segal Company prepared an estimated Accrued Actuarial Liability (AAL) of the retirement system for use in calculating the twenty-one hundredths of 1 percent policy cap.

Mr. White began the discussion with staffing and the need to add one full-time equivalent position, an Accountant, to the MCERA administrative staff and to re-classify one existing full-time position, a Retirement Specialist II, as an Administrative Assistant. The Accountant position previously approved by the Board at its April meeting would be staffed as a 32 hour position with benefits. The proposed budget was prepared to include the cost of a 40 hour position which was done as a conservative approach. The difference in the cost between 40 and 32 hours is $12,735. The Administrative Assistant position is intended to align the current job duties performed by a retirement specialist that are likely now being done outside of the scope of that job class specification. Once reclassification is complete a Retirement Specialist II position would be eliminated. The difference in salary is an increase of $1,319.10.

Next the Board reviewed the proposed budget worksheet beginning with Administrative expenses. Mr. Stephens asked about the cost to prepare the estimated AAL and asked staff to report back to the Board on the amount. Both he and Supervisor McCowen requested a projected actual budget for comparison. Legal Expense was discussed and Mr. Stephens asked about the remaining Buck settlement funds. Mr. Weer and Mr. White replied that the account will be swept at the end of this fiscal year to cover the County Contribution Correction Project expense and that the County had not billed for their costs yet.

Mr. Stephens asked about Contracts and why we were budgeting for a contract accountant and a full-time accountant position. Mr. White added that the Audit and Budget Committee had recommended the overlap because recruitment will take time and accounting services must be provided for during the process and during the training of the new employee. The contract budget would allow for six months of contract accounting services, but would be reduced if six months is not needed and the same would apply to the budget for the full-time accountant.

The Board education and conference budget was increased due to Board policy and State requirements. It was mentioned that Board member meeting attendance stipends have traditionally been included in this budget item. Board members agreed that the stipends should be tracked separately and removed from this item total. Supervisor McCowen felt the resulting total may be less than adequate for Board member education and will need review if there is a need. It was also mentioned that viewing DVD recordings of SACRS meetings would qualify as continuing education and Board members were encouraged to utilize this option.

Mr. White stated that Disability Due Diligence was reduced by half because the Administrative Assistant would be doing much more with incoming disability applications which would reduce legal fees associated with the processing of disability applications. The Medical Reviews budget will increase due to our use of a medical advisor and specialists for independent medical evaluations.

Board Direction: Staff will determine the cost of preparing an estimated AAL by the Segal Company to report to the Board and will prepare a projected actual budget for comparison. The Retirement Administrator will bring information to the Board regarding Board of Supervisors approval of the new positions and how long the recruitment process may take in order to determine when the new accountant will start. Board member stipends for meeting attendance will be accounted for in a different category other than Board Education and Conferences. Staff will continue to provide quarterly budget reports.

Board Action: Motion was made by Mr. Sakowicz to approve the Fiscal Year 2013/14 Budget as presented so that the Retirement Administrator can proceed with discussion with the County Chief Executive Officer (CEO). Mr. Mirata seconded the motion and it was approved by the following vote: Ayes 7 Noes 1 (Stephens) Abstain 0 Absent 1 (Motion Approved)

5) DISCUSSION AND POSSIBLE ACTION REGARDING AUTHORIZED SIGNATURE RESOLUTION 2013-02

Board Action: Motion was made by Mr. Mirata to approve the Authorized Signature Resolution 2013-02. Supervisor McCowen seconded the motion and it was approved by the following vote: Ayes 8 Noes 0 Abstain 0 Absent 1 (Motion Approved)

6) DISCUSSION AND POSSIBLE ACTION REGARDING THE STATE ASSOCIATION OF COUNTY RETIREMENT SYSTEMS (SACRS) BUSINESS MEETING MAY 17, 2013

Presenter/s: Rich White reference information previously distributed to the Board regarding the SACRS business meeting scheduled May 17, 2013.

Board Direction: The voting delegate, Rich White, will vote as he feels appropriate.

LUNCH RECESS (Approximately 12:23 p.m.)

RECONVENE (Approximately 1:30 p.m.)

7) CLOSED SESSION

- **Pending disability applications update**
- **Tim Goss SCD Application**
- **Kim Koskinen Writ of Mandamus**

♦RETIREMENT ASSOCIATON CONFERENCE ROOM: 625-B KINGS COURT, UKIAH, CA 95482♦
♦PHONE 707-463-4328 FAX 707-467-6472♦ WWW.CO.MENDOCINO.CA.US/RETIREMENT♦

REPORT OUT FROM CLOSED SESSION

Board Direction: The Board provided direction to staff and Counsel regarding Mr. Goss.

Board Action: There was no action taken on Kim Koskinen.

8) BENEFITS AND OPERATIONS

- **Active Membership and Retirements as of April 30, 2013:**
  Active Members = 1018 Retired Members = 1280 Retired Deceased = 1
  New Members = 16 Terminations = 4 Withdrawn Not Vested = 2 $2,890.54
  Withdrawn Vested = 2 $76,761.44
- **Retirements Processed in April (20):**

Carl Crelly	**3/29/13**	**DOT**
Steve Alvarado	**3/30/13**	**Sheriff**
Richard Mummert	**3/29/13**	**DOT**
Jeff Wachtel	**3/29/13**	**Social Services**
Linda Kelly	**3/22/13**	**DSS**
Leslie Kirkpatrick	**3/29/13**	**AODP**
Larry Alexander	**3/31/13**	**DOT**
Sandra Applegate	**3/30/13**	**County Counsel**
Carol Brown	**3/29/13**	**PH**
James Brown	**3/29/13**	**Probation**
Christy Conrardy	**3/30/13**	**DA**
Brigitte Jacks	**3/28/13**	**Treasurer**
Ann Hershberger	**3/29/13**	**DSS**
Leslee Woll	**3/29/13**	**Auditor**
Evelyn Parsons	**3/31/13**	**DSS**
Pat Meek	**3/31/13**	**HR**
Sharon Hunt	**3/29/13**	**PH**
Sue Goodrick	**3/30/13**	**HR**
Vivian Caldwell	**3/30/13**	**Courts**
Leslee Woll	**4/1/13**	**Spousal Continuance**

9) MONTHLY FINANCIAL REPORT

- **Statement of Plan Net Assets**
- **Statement of Changes in Plan Net Assets**
- **Cash Flow Analysis**
- **Vendor Ledger**
- **Update on Kings Court Asset**

Presenter/s: Rich White referenced information previously distributed to the Board including statement of plan net assets, statement of change in plan net assets, cash flow analysis, vendor ledger, and an update on our Kings Court real estate asset. Mr. White explained Kings Court asset including its use, rent, imputed rent, expenses, and how these are accounted for in the monthly statements.

10) DISCUSSION AND POSSIBLE ACTION REGARDING THE INFORMATION TECHNOLOGY (IT) ROADMAP (Estimated Time 15 min.)

- **Pension Administration System (PAS)**

Presenter/s: Rich White referenced information previously distributed to the Board regarding our Information Technology (IT) Roadmap. He recapped our previous IT Roadmap document, adopted in January 2011, and highlighted certain components for the Board, reminding them that this document was over two years old now. He added that the Electronic Document Management System (EDMS) was halted in August of 2012 when the project expanded beyond the scope of the approved roadmap as a result of conditions outside the control of the Association and Linea Solutions. The Board approved the Board Strategic Plan in January of this year which contained objectives for MCERA to revisit the previously prepared IT Roadmap and to evaluate various service providers and implement an automated pension administration system.

Over the past few weeks staff has worked with Linea Solutions to develop a Request for Proposal (RFP) for a pension administration system. The intent is to select a solution provider to supply MCERA with an automation system that will facilitate all pension administration business functions, while improving member services and operations. The RFP was released on May 1, 2013.

Board Direction: Chair Schapmire appointed Mr. Knudsen and Mr. Weer to an Ad Hoc IT Roadmap Committee. The committee will participate in the evaluation of the RFP submissions and will assist staff in making recommendations to the Board.

11) RETIREMENT ADMINISTRATOR'S REPORT

- **Meetings attended**
- **Board Agenda**
- **Future meeting attendance**

Presenter/s: Rich White referenced information previously distributed to the Board.

<u>Meetings Attended</u>
April 23, 2013, SACRS special education session in San Francisco.
May 1, 2013 Mendocino County Department Head meeting.

<u>Board Agenda</u>

A Board member requested adding a consent calendar to the regular Board agenda. Due to time constraints, the Board has not had a full discussion regarding the merits in the use of a consent calendar.

Future Meeting Attendance

May 14-17, 2013 SACRS Spring Conference in Napa.
June 2-5, 2013 Government Finance Officers Association (GFOA) 107th Annual Conference in San Francisco.

Supervisor McCowen spoke regarding a consent calendar. Some agenda items could be included and taken care of in one action saving meeting time. Only routine items would be included in the consent calendar. Board members could contact staff with any questions they may have prior to a meeting and any Board action.

Board Direction: Staff will include a consent calendar in the next meeting agenda.

12) COMMUNICATIONS

- **Article entitled False Sense of Security, Plan Sponsor Magazine**

13) GENERAL BOARD MEMBER DISCUSSION

ADJOURNMENT (2:40 p.m.)

Richard A. White, Jr.
Retirement Administrator

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MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date: June 19, 2013
To: Board of Retirement
From: Richard White, Retirement Administrator RAW
Subject: Administrator Report

Meetings attended since the last Board of Retirement meeting:

- I attended the State Association of County Retirement Systems (SACRS) Spring 2013 Conference in Napa, CA. I attended the conference sessions, moderated the Administrator breakout session and represented the Board as the voting delegate at the Business meeting.
- I attended the Board of Supervisor meeting on May 21 and made brief comments about the most recent Board of Retirement meeting during the public expression period.
- I met with County CEO and Interim Human Resources Director Carmel Angelo regarding the recently passed MCERA fiscal year 2013/2014 budget.
- I attended the Government Finance Officers Association (GFOA) 107th Annual Conference on June 2-5, 2013 in San Francisco.

Future meeting attendance:

- I will be attending the California Association of Public Retirement Systems (CALAPRS) Administrator Roundtable on June 21, 2013 in Burbank.
- I will be attending the Callan Regional Workshop on June 26, 2013 in San Francisco.

Update regarding Small Claims Court Judgment: MCERA v. Craig Lindburg:

- The case was heard on May 24, 2013 and a judgment in favor of MCERA for the $3,000 overpayment was submitted by the Court. Mr. Lindburg will be notified by mail of the judgment and will have 30 days to appeal it.

MCERA Office Hours:

- MCERA will be closed on Friday, July 5, 2013 to give our staff a long holiday weekend. Many County offices will also be closed to the public on this date as well.

Richard A. White, Jr.
Retirement Administrator

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MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
UKIAH, CALIFORNIA 95482-5027

Date: June 19, 2013
To: Board of Retirement
From: Richard White, Retirement Administrator RAW
Subject: Communications

The following items are provided for your reading and reference:

1. Contra Costa County Retiree Health Care Update in Courthouse News Service, May 13, 2013. (Submitted by Board Vice Chair Weer).

2. Pension Poster Child by W. Zachary Malinowski in American Planning Association, March 2013. (Submitted by Board member Shoemaker).

3. The Divestment Debate by Penelope Lemov in Governing Magazine, May 2013.

4. Economic and Market Perspective Update by Jim Paulsen, Wells Capital Management, May, 17 2013.

5. Inviting Citizens to the Digital Town Square by Ryan Holeywell, Governing Magazine, May 2013. (Lieutenant Govenor Gavin Newsome was a keynote speaker at the SACRS Spring 2013 Conference.)

Courthouse News Serv

Monday, May 13, 2013 Last Update: 6:07 AM PT

By CHRIS MARSHALL

This Tweet

SAN FRANCISCO (CN) - A northern California county cannot avert claims over its alleged attempt to stop providing retirees with health care, a federal judge ruled.

The Retiree Support Group of Contra Costa County sufficiently alleged that a contract existed in which Contra Costa County agreed to pay 80 percent of health care benefits to retirees and their dependents associated with at least one plan for the lifetime of the retirees, according to the ruling.

In a February 2012 complaint, the support group said its workers "gave up wage increases and other employment benefits in order to receive [the] health care benefits," but that the county capped contributions at a flat dollar amount in 2010 and said it would pass on the increased cost of health care to the retirees.

U.S. District Judge Jeffrey White dismissed the original complaint in July 2012, finding that the allegations failed to establish the existence of a contract.

The groups amended fared better Wednesday with U.S. District Judge Jon Tigar, finding that the group may able to show that county memorandums or resolutions "clearly evince an intent" to grant vested retiree benefits.

"The California Supreme Court held that a resolution or ordinance may contain implied terms created vested rights to retiree health benefits," Tigar wrote.

In *Retired Employees Association of Orange County Inc. v. County of Orange*, or *REAOC*, the court held that vested rights can be implied if there is a "clear basis in the contract or convincing extrinsic evidence," according to the ruling.

In considering how *REAOC* applied to nearly identical claims in a separate case, the 9th Circuit said a complaint could survive dismissal if it "plausibly allege[s] that the county: (1) entered into a contract that included implied terms providing healthcare benefits to retirees that vested for perpetuity; and (2) created that contract by ordinance or resolution."

Here the retirees satisfied both requirements by "alleging that the county explicitly promised health care benefits to the retirees in ratified [memorandums of understanding] and board resolutions, and by alleging that the ratified [memorandums] and resolutions included implied terms containing the 80% promise," Tigar wrote.

They cited specific memorandums and resolutions in which the county "agreed to provide retiree health benefits to eligible retirees," and they pointed to "testimony of former labor negotiators and county officials who participated in the negotiations of the [memorandums of understanding] and resolutions, various statements by members of the Board of Supervisors and county officials, pension materials and booklets, [and] the county's longstanding practices," according to the ruling.

These allegations "are sufficient to raise the reasonable inference that the county intended to contractually bind itself to provide to the retirees lifetime health care benefits in accordance with the 80% promise," Tigar added.

As to the second requirement, the retirees adequately alleged that the 80% promise "was the result of a bargained-for exchange of considerations," the court found.

Contra Costa also did not point to any authority that required a claim for breach of an implied term in a ratified memorandum of understanding or resolution "be dismissed as a matter of law at the pleading stage on the basis that the [memorandum of understanding] or resolution at issue contains a durational clause."

Here, the support group "has pled sufficient facts to raise the reasonable inference that the county made the 80% promise," Tigar added.

Contra Costa also furthermore did not show that the anti-vesting provisions in California Government Code Section 31692 bar the claims.

The section provides that "the adoption of an ordinance or resolution pursuant to Section 31691 shall give no vested right to any member or retired member, and the board of supervisors or the governing body of the district may amend or repeal the ordinance or resolution at any time," according to the ruling.

Section 31691 authorizes a county board of supervisors to provide, by ordinance or resolution, for the county to contribute to premiums for life or disability insurance or toward the payment "of all or part of the consideration for any hospital service or medical service corporation ... for the benefit of any member heretofore or hereafter retired or his or her dependents. At least one of these plans shall include free choice of surgeon or physician."

Tigar noted, however, that the "precise relationship" between the services detailed ir the codes "is unclear because another section of the California Government Code, namely Section 52301, authorizes counties to provide 'health and welfare benefits' to retired employees, and such benefits are not subject to the restrictions of Section 31692. Because the county has not presented evidence or authority that the court may consider on a motion to dismiss showing that the benefits at issue are governed by Section 31692 and not by Section 53201, the county's argument that [the retiree support group's] claims are barred by Section 31692 is unavailing."

Associational standing is also proper at this juncture since the group's members would have standing to sue in their own right, according to the ruling.

In this same vein, the group seeks to protect interests that are germane to its purpose. Additionally neither the claim asserted nor the relief requested requires the participation of individual members, Tigar concluded.

American Planning Association *Making Great Communities Happen*

Planning — March 2013

Pension Poster Child

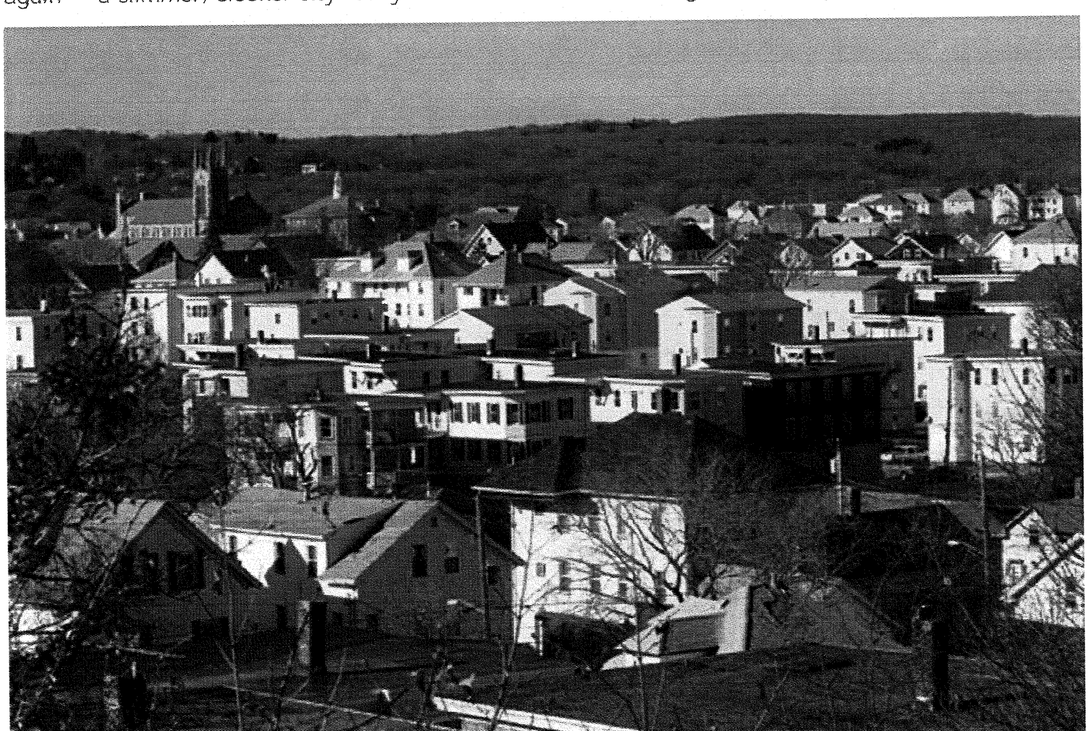
Rhode Island's smallest city emerges from bankruptcy partly by renegotiating its long-term obligations.

By W. Zachary Malinowski

Rumors had been swirling around the impoverished city of Central Falls for months, but still, the historic announcement stunned the crowd in the sweltering city hall council chambers. Rhode Island Gov. Lincoln Chafee, a former U.S. Senator, and Robert G. Flanders Jr., the state-appointed receiver charged with straightening out the city's finances, announced on August 1, 2011 that Central Falls had filed for Chapter 9 bankruptcy.

The smallest city in the nation's smallest state had just attained the dubious distinction of being the first municipality in Rhode Island to declare itself insolvent and seek bankruptcy protection in federal court.

"Services have been cut to the bone," said Flanders from the lectern on the council dais. "Taxes have been raised to the maximum level allowable. From the ashes of bankruptcy, Central Falls will rise again — a slimmer, sleeker city ready to stand on its own two legs as an independent municipality."



Trouble brewing

The bankruptcy filing was a shot heard across the state, region, and nation. Central Falls (pop. 19,500), a 1.3-square-mile city about six miles from Providence, became a microcosm for the poor economy nationwide and especially Rhode Island, whose unemployment rate currently ties for first place with Nevada's.

A 2011 report written by the Rhode Island auditor general reported that 24 of the state's 36 municipal pension plans are in distress, including those in Providence, the state capital, and many of those two dozen may soon join Central Falls in bankruptcy.

Two weeks before the bankruptcy announcement, Flanders had met with more than 100 retired firefighters and police officers in the steamy auditorium of Central Falls High School. There, he shocked the pensive audience members by saying that they had to accept substantial cuts — up to 50 percent in their retirement benefits — to save the city about $2.5 million a year.

The glory days when Central Falls had been a bustling manufacturing hub had long passed and the city was broke. Elected officials had failed to make, or woefully underfinanced, their annual payments to the pension plans. The pension problem, coupled with generous health benefit packages, had left the city with about $80 million in unfunded liabilities.

If the retired firefighters and police officers thought that Flanders was bluffing, they quickly learned otherwise. He urged the retirees to take the pension cut, saying that "a haircut is better than a beheading."

Lawyer Michael W. Long, a retired police sergeant, was furious. He wanted Flanders to give the pensioners time to study his proposed reductions and come up with possible alternatives. Flanders refused to wait.

"Bad day," said Long outside City Hall. "I'm disappointed with the way things turned out. Flanders never negotiated with the retirees. Never."

Learning the meaning of Chapter 9

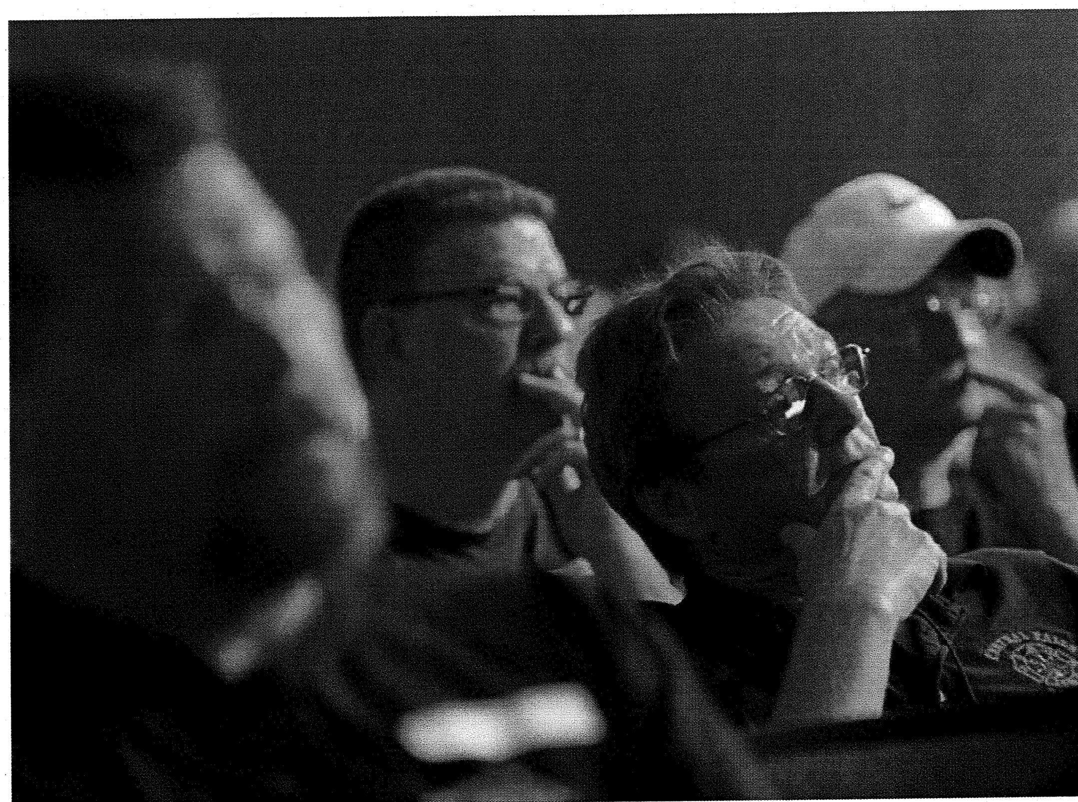
Chapter 9 bankruptcy filings are rare but are becoming increasingly common in distressed municipalities across the nation. In California, Stockton and San Bernardino declared themselves insolvent last summer. Vallejo, California, and Prichard, Alabama, had already filed for bankruptcy.

Vallejo (pop. 115,000) and Stockton (pop. about 300,000), California's tenth largest city, have reduced the number of firefighters and police officers on staff, though officials in each city have been reluctant to touch the retirement pensions. The cuts have resulted in a crime surge in Stockton, now called the "murder capital of California."

Stockton's unfunded pension liability has reached $800 million, and San Bernardino is in a fix as well. Last fall San Bernardino stopped making required biweekly payments totaling $6 million to the California Public Employee Retirement System, the world's largest pension fund. San Bernardino claims it owes Calpers $143 million, while Calpers says the figure would be closer to $320 million if the city were to leave the state plan.

Karol K. Denniston, a San Francisco lawyer and expert on municipal bankruptcy, says it's just a matter of time before Stockton, San Bernardino, or another distressed city challenges the California law prohibiting cuts in retirement pension funds.

"It's just a question of who gets there first," Denniston says. "The money has to come from somewhere. People in California are just starting to realize that revenues generated from municipalities are not going to be enough" to cover pension obligations.



Drastic steps, quick turnaround

Rhode Island differs from California. Rhode Island's Fiscal Stability Act, adopted in June 2010, allows the state department of revenue to appoint a receiver to restore fiscal balance in individual municipalities as needed. Once appointed, the receiver assumes the powers of the mayor and city council and has broad powers to take whatever actions are necessary to lift a city or town from financial ruin. Those actions include filing for Chapter 9 bankruptcy and unilaterally changing the contracts with unionized workers and retirees.

Flanders, a former state supreme court justice, targeted the fire and police pensions to slash nearly half of Central Falls' projected annual debt of $6 million over the next five years. That's a huge financial burden in this tiny city, whose annual budget is $17 million.

The decision to slash the retirement benefits resulted in a turbulent year that often pitted Flanders and his staff against the elected officials who had been stripped of their powers. There was at least one death threat and many complaints from residents that they were living under a dictatorship.

Fifty-six of the city's 174 jobs were eliminated or left unfilled. The community center and library were shut down; other city buildings were sold, including a former school that was too expensive to maintain. The police chief — who was collecting more than $160,000 annually from his salary, pension, and benefits — was axed. The receiver felt a police major could do the chief's job for less pay.

Local politicians and other critics complained that the state's poorest city had to pay Flanders, lawyers, and other appointed officials $3.8 million. They were also irritated that Flanders was an "outsider" who lived in tony East Greenwich, wore expensive suits, and drove a Porsche.

But, in October 2012, less than 15 months after Central Falls was declared insolvent, the city emerged from bankruptcy. U.S. bankruptcy judge Frank J. Bailey, who presided over the Central Falls bankruptcy, commended the state and its three receivers for rescuing the city from financial ruin.

"I would certainly identify the receivers for their efforts, expertise, and wisdom for moving this case along," said Bailey from the bench. "In my limited knowledge, this is the fastest case to go in the history of Chapter 9. It's a record time and record efficiency. I know that the fees are in the millions of dollars, but they're no match for what fees have been in similar cases."

In contrast, the much larger city of Vallejo, California, took more than three years and spent more than $8 million to emerge from bankruptcy, while estimates for the Stockton bankruptcy have been as high as $20 million.

Oddly enough, the loudest critics of the Central Falls receivership and bankruptcy — the mayor and his four allies on the city council — were the ones who petitioned the state to intervene. That was in May 2010. Two months later, the state appointed retired judge Mark A. Pfeiffer as the city's receiver. He went right to work, barring the mayor from city hall, slashing his $73,000 salary to $26,000, and reducing the role of the council to advisory status.

Mayor Charles D. Moreau and the four city councilors sued in state court, claiming that the receiver had unlawfully stripped them of their powers. A prolonged court battle ensued in the state superior and supreme courts. In the end, the state prevailed and a judge ordered Mayor Moreau and the four councilors to repay the city about $300,000 in court costs. They are each on the hook for $60,000.

In early 2011, Flanders was appointed the city's second receiver. He and Gayle A. Corrigan, his chief of staff, made wholesale cuts and determined that bankruptcy was the only way out of the city's fiscal mess.

What was uncovered

Disability pensions were a big problem. A review of city records showed that more than 55 percent of the retired firefighters and police officers were collecting disability pensions — two-thirds of their salaries tax free — for injuries incurred on the job. Between 1978 and 1988, 82 percent of the public safety workers left with injuries they claimed they suffered while on duty.

Hypertension and stress was the leading cause of the job-related disabilities, afflicting more than 40 percent of the disabled firefighters and police officers. Their average age of retirement or disability was 46, meaning that the city was burdened with millions of dollars in pension payments for decades to come.

"Granting somebody a disability pension is one of the more fiscally important decisions a city or town can make," Corrigan says. "If everybody goes out on a disability when they are 25 or 26, you own them for life."

A few cases generated plenty of attention. One firefighter went out on a disability pension with chronic back problems. Sixteen months later, he ran a 3.1-mile road race and averaged 5:32 per mile, a phenomenal pace for a 46-year-old man.

One of the state's most successful personal injury lawyers also got a disability pension. Robert J. Levine, a Central Falls police officer, left the force after six years on the job after he was involved in a minor accident while driving his police cruiser. He was granted the disability pension soon after the city paid for his law degree and he took the Rhode Island bar exam.

Over the past 12 years, Levine has collected more than $300,000 in disability income while establishing a successful law practice that has allowed him to live in a million-dollar house in East Greenwich. He refers to himself as "The Heavy Hitter," and his smiling face can be seen on television advertisements and billboards across Rhode Island and southeastern Massachusetts.

Pitching in

The city's layoffs and library closure were short-lived. Volunteers rallied and quickly reopened the ornate, Greek-revival style building, just a short walk from city hall. Last year, the library raised about $125,000, partly from sizeable donations from actors Alec Baldwin, Meryl Streep, and Viola Davis. Davis had grown up in a rat-infested apartment in the city and graduated from Central Falls High School.

Corrigan and her staff also had productive contract negotiations with the unions representing the firefighters, police, and municipal workers. The old collective bargaining agreements had been discarded during the receivership. The new deals upped the length of service before retirement from 20 to 25 years and called for all city employees to pay 20 percent of their health benefits.

These arrangements replaced a deal that had been made in 1992, when a negotiated contract with the firefighters and police unions first established that their members could retire after 20 years, a move that immediately increased the required annual pension fund payments from $700,000 to $2 million. The city never came close to making those payments, and for several years no money was pumped into the retirement fund.

In addition, by 2011 Moreau and his two predecessors as mayor had raised property taxes only 3.2 percent over 19 years.

In 2012, firefighter and police unions also agreed to make it harder for their members to go out on disability pensions. In the past, a public safety worker could leave on a disability pension if two doctors determined that he had hypertension and didn't improve within 60 days. Now that time period has been extended to 12 months, meaning that firefighters or police officers can exercise, diet, or take medication to lower their blood pressure.

Work was being done behind the scenes to make all this happen. Rosemary Booth Gallogly, the state revenue director, and Ted Orson, a bankruptcy lawyer for the receiver, were negotiating a deal with those representing the retirees. Gallogly and Orson got members of the general assembly to agree that the state provide 108 retired police officers with $2.6 million over the next five years.

At last, after months of bad blood between the receiver and the public safety workers, representatives from the three unions hailed Flanders and Corrigan for their transparency during the talks, saying that the new pacts will ensure the workers' future pensions.

The bailout didn't make the retirees whole, but it bumped their retirement pensions up to 75 percent of what they had been making before the cuts. The deal was the clincher that brought the bankruptcy to a conclusion. In addition, since Flanders and Corrigan arrived, no firefighters or police officers have left with disability pensions.

On the horizon

The end of the bankruptcy and receivership does not mean that the state's oversight of Central Falls is over. Corrigan and her staff hammered out a lengthy Plan of Debt Adjustment that has set annual city budgets through 2017. The plan, which was approved by the federal bankruptcy court, restricts spending for new hires, capital improvements, and other operating costs for the next five years. If the mayor and city officials deviate from the budgets, they must answer to the state revenue director. The director could drag them back into bankruptcy court, where they would be subject to fines or jail sentences for violating the terms of the plan.

The receiver's drastic actions placed other cities on notice across the state. Providence, which was on the verge of bankruptcy in February 2012, reopened negotiations with its municipal, fire, and police unions. Led by Mayor Angel Taveras, the state's first Latino mayor, the city worked out major concessions with the all three unions that include a freeze on cost of living adjustments for 10 years and eliminating compounded increases of five and six percent.

Providence's cost of living increases will return in 2023 only for retirees with pensions less than 150 percent of the state median income, currently $82,353. As in Central Falls, the retirees no longer get lifetime medical benefits. Now they will move to Medicare when they turn 65 years old.

Providence officials expect that the changes will reduce the city's unfunded pension liability by as much as $170 million and the switch to Medicare will save $40 million over the next decade. City officials are ironing out several procedural and technical steps before the reforms take place on April 1.

There's a flicker of hope in Central Falls as 2013 unfolds. It's been a difficult stretch, but the city's fiscal house is in order for the first time in years. The receivership has yet to end and it continues to cost the city $9,400 a week. The state wants to leave and restore the powers to the elected officials. Two weeks before Christmas, voters returned to the polls and elected as mayor James A. Diossa, the son of Colombian immigrants. He is the first Latino mayor in the city's history and just the second in Rhode Island.

Diossa, age 27, replaced Moreau, the ex-mayor, who pleaded guilty to a federal corruption charge last fall and was sent to prison for two years. Four of the five members of the city council rubber-stamped everything that Moreau wanted. Diossa, elected to the council in 2009, was the sole contrarian. The city is now more than 60 percent Latino and that constituency is thrilled to see one of its own running Central Falls for the first time since it was incorporated in 1895.

But challenges do remain. The median family income in Central Falls is $26,844, considerably lower than the U.S average of $50,046, and about 26 percent of the population lives below the poverty line.

And then there is the tax problem. Pfeiffer, the second receiver, increased property taxes by 20 percent, and under the debt adjustment plan, those taxes will increase another 20 percent over the next five years.

The three state-appointed receivers that ran the city for more than two years made several moves that changed the old culture of rewarding political supporters with patronage jobs in city hall. Several of those jobs were eliminated to save money, including the director of code enforcement — a friend of the former mayor who was not licensed to conduct inspections — and the recycling coordinator.

Planner's view

Stephen Larrick, a 2011 graduate of Brown University, the Ivy League institution on the East Side of Providence, is one of the fresh faces in Central Falls. He came to the city as a summer intern and in September 2011 was hired as a planning and economic development officer for $41,307 a year.

Larrick, who majored in urban studies and political philosophy, lives in Boston and commutes by train each morning to a stop in neighboring South Attleboro, Massachusetts. There, he hops on his bike and pedals to work in Central Falls. The commute takes him about 75 minutes one way.

He likes the fact that the city is "99 percent built out," and feels that its elected officials should "embrace our density." "Young people are moving back to cities," Larrick says. "We should open ourselves up to the Providence and Boston metro markets."

A key to the future is a plan to construct a Massachusetts Bay Transportation Authority train station in Central Falls. Currently, there are stops in Providence, Warwick, and Wickford, a quaint village in the southern part of Rhode Island.

Central Falls is the next scheduled stop, though the project is not expected to begin for several years and its completion date is scheduled for 2022. Still, the Central Falls and Pawtucket area will eventually reap the benefits of an economic boom as out-priced commuters will be searching for cheaper housing beyond Boston and Providence. Another plus is that Central Falls is seconds from Interstate 95, the major East Coast highway that runs from Maine to Florida.

Meanwhile, Larrick sees opportunity on the Blackstone River waterfront. Right now, about 100 loft condominiums have been carved out of the old brick mill buildings there, and plans are under way for 80 more. Some are as large as 2,800 square feet and rent for $1,300 to $2,400 a month.

Larrick dreams about cafes, shops, restaurants, and businesses that will cater to the doctors, lawyers, merchants, and artists living in those lofts. He knows that the city's receivership and bankruptcy have left a stigma, and he's eager to help turn things around. "This is where I want to be right now," he says.

W. Zachary Malinowski is an investigative reporter for the Providence Journal.

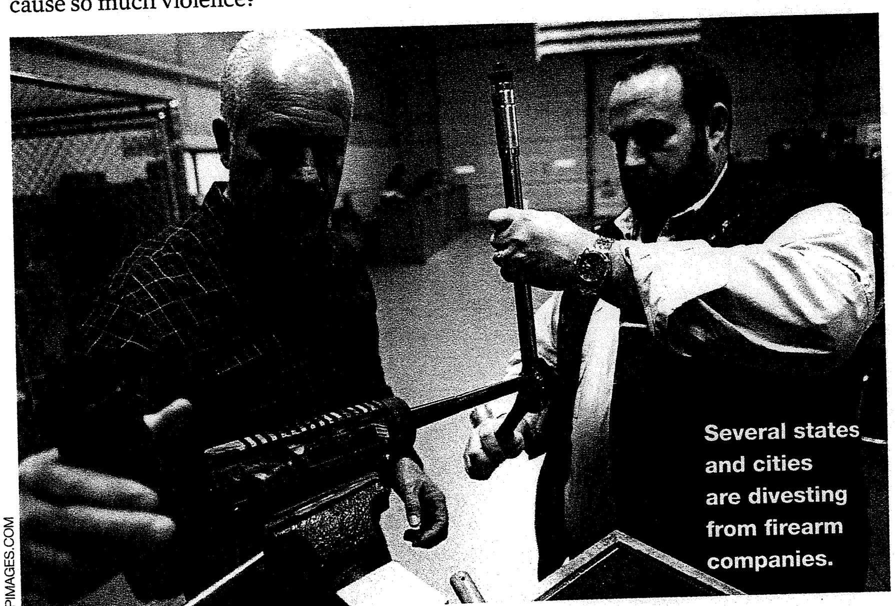
Resources
Images: Top —The city of Central falls, Rhode Island. Photo by Mary Alice Murphy. Middle — A retires Central Falls fire captain and other retirees listen in at a public meeting regarding cuts to their pensions. Photo Gretchen Ert/ The *New York Times*. Bottom — The city's library has solicited donations to help it keep the doors open. Photo Evan McGinn/ The *New York Times*.

By Penelope Lemov

The Divestment Debate

Social investing says a lot about a city's heart and soul. But should pensions do it?

After last year's mass shootings in Aurora, Colo., and Newtown, Conn., several state and local officials sat down and took a good look at their pension portfolios. Was it responsible, they asked, for the public to support gun manufacturers, especially when guns were being used to cause so much violence?



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Several states and cities are divesting from firearm companies.

For state officials in California and New York and mayors in Chicago and Philadelphia, the answer was no. They, along with other cities and states, have announced plans to purge their portfolios of firearm companies. It's called social investing—or disinvesting—and it has a long history.

When there was an outcry against apartheid in the 1980s, a number of public pension plans dumped the stock of companies doing business in South Africa. Several cities divested from companies involved with the Sudan after reports of genocide in Darfur. More recently, a number of pension plans have refused to invest in companies that deal in tobacco or alcohol.

Social investing taps into highly emotional issues, and tries to turn that emotion into action. In Chicago, Mayor Rahm Emanuel has been agitating for the city's five pension funds to divest from firearm manufacturers, saying, "We cannot support or invest in companies that profit from the proliferation of assault weapons and the violence these guns bring to our communities."

For New York City Public Advocate Bill de Blasio, a trustee for the city's $43.3 billion employee retirement system, "it's a bad investment to put money behind companies that put military-grade weapons on our streets and refuse to take responsibility for the outcome," as he told the Associated Press. "We should not be giving capital to an industry that is responsible for the deaths of thousands of Americans each year."

But is social investing fiscally responsible? Research suggests that funds that screen out companies based on social values tend to perform just as well as unscreened portfolios. At the same time, some individual funds' returns have been harmed by value-screening.

Alicia Munnell, director of the Center for Retirement Research at Boston College, is an outspoken critic of social investing. After years of social investment decisions in regard to South Africa, the Sudan and other countries and causes, Munnell sees fiscal peril in forcing portfolio managers to add non-monetary considerations to investment decisions. "Introducing another dimension creates a risk that portfolio managers will take their eyes off the prize of maximum returns and undermine investment performance."

As she sees it, the people making the social investment decisions are not the people who will bear the burden if anything goes wrong. "If divestiture produces losses either through higher administrative costs or lower returns," she says, "tomorrow's taxpayers will have to ante up or future retirees will receive lower benefits."

Private pension plans, which are governed by the Employee Retirement Income Security Act, are prohibited from social investing. Munnell believes public plans should follow suit. Not that there isn't room for other groups to do social investing. "If rich people want to adjust their own portfolios, that is perfectly reasonable," she says. "But for public plans to do it is not."

Social investment advocates argue they have a moral responsibility to society. As Chicago Alderman Will Burns put it earlier this year, "The damage caused by these weapons is far greater than any return on investment."

It's a strong argument, and one that Munnell says makes her position "not a pleasant one." When the genocides in Darfur were occurring and pension plans were talking of disinvesting, Munnell disagreed vocally with that policy. "I sounded pro-genocide. Now I sound anti-gun control. I'm neither. I just don't think social investing is effective. It can harm the performance of public plans." **G**

Email plemov@governing.com

WELLS CAPITAL MANAGEMENT

UPDATE

Economic and Market Perspective

"Bringing you national and global economic trends for more than 25 years"

May 17, 2013

Confidence Runs Through the Stock Market

For the first time in this recovery, confidence is dominating fear in the stock market. Rather than suggesting irrational exuberance, this show of confidence may actually be a step toward rationality. Perhaps, emotional health is finally returning to an investment community severely scarred by the 2008 collapse which produced an obsession over multiple and mostly unrealistic calamity scenarios and widespread symptoms of "Armageddon psychosis."

Many remain baffled by a stock market which has risen to all-time record highs in an economic recovery whose growth rate has persistently been subpar compared to historic norms. A common refrain is the stock market cannot be rising because of economic performance so it must only be going up because of constant liquidity injections from the Federal Reserve. For many, the stock market is just one big sugar high which is entirely divorced from underlying economic performance and is therefore headed for another day of reckoning.

Since the financial collapse in 2008, however, the driving force behind the stock market recovery has not been the "speed" of economic growth. Rather, it has been a slow but steady recovery from the psychological depths of investor despair. Since 2008, the stock market has been priced for a depression, for another major bank failure, for massive municipal bond defaults, for a secondary collapse in the housing industry, for a run on the U.S. dollar, for a breakup of the eurozone, and etcetera ad nauseam—none of which actually occurred. Essentially, the stock market has mostly risen in recent years because, although priced for it, the "end of the world" never happened. Subpar economic performance while perhaps disappointing is still worth more than a depression.

Indeed, in the last 18 months, the U.S. economy has broadened significantly and is now firing on more cylinders than ever. This has created a sense the recovery is now much more sustainable and less vulnerable to external shocks. Over this period, the average monthly pace of job creation has been near the best of the recovery at about 175 thousand. The unemployment rate has declined steadily and by the largest amount of the recovery even while the labor force has grown at its fastest pace of the recovery. Consumer confidence, which was mirrored at post-war lows earlier in the recovery, is now near a five-year high. U.S. household net worth has been almost entirely restored to pre-crisis levels and the household debt service burden has declined back close to a record low. After falling until late-2011, total U.S. bank loans have since been rising steadily. Similarly, both housing activity and home prices have finally come to life in the last 18 months. Aggregate state tax collections recently rose to a new all-time high probably ending a persistent loss of state jobs. Corporate profits continue a steady advance and are now more than 20% higher than the peak of the last recovery cycle in 2006. Recently, the greatly feared federal government deficit seems to be melting away much faster than anticipated and suddenly the U.S. has achieved energy independence. Finally, in just the last couple months, the U.S. stock market rose to new all-time record highs.

We disagree with those who suggest the economy has shown no signs of improvement or at least not enough to justify the explosive rally of the stock market. While the pace of economic growth remains slow, the character of this recovery has improved dramatically. Since 2008, most investors have chronically feared that the economic recovery could be violently and prematurely aborted by some calamitous event. Recently, however, the recovery has broadened and now appears more sustainable. Consequently, investors have finally begun to "elongate investment horizons" producing a rally driven by rising valuations precipitated by recovering confidence. Even though not widely perceived, the rally on Wall Street is very much tied to performance on Main Street. Not to the speed of economic growth or profits, but rather to a significant calming in fears and a sizable improvement in Main Street and Wall Street economic psyches.

Evidence of rising stock market confidence

There are several examples of confidence recently running through the stock market. Chart 1 illustrates the trailing 12-month price-earnings (PE) multiple for the S&P 500 Index. In 2010 and 2011, the PE multiple chronically eroded as confidence was shaken by an eurozone crisis and by the U.S. losing its AAA rating among other apprehensions. However, since 2012, the PE multiple has risen as confidence in the sustainability of the recovery improved and as sensitivity to economic calamity stories diminished. In 2012, the S&P 500 Index rose by about 13%—about 10% of this gain was due to a rise in the PE multiple from about 13x at year-end 2011 to about 14.5x by the end of 2012. Similarly, the stock market has increased by about 16% so far in 2013 as the PE multiple has increased to about 16.3x or added about 12% to the year-to-date performance. As illustrated in Chart 1, since late-2011, this has been a confidence-driven stock market reflected in a steady rise in the PE multiple to its highest level in more than three years.

Another sign of rising confidence in the stock market is shown by the relative total return performance of stocks compared to bonds (Chart 2). Stocks have irregularly outpaced bonds since late 2011 and currently are near the highest level of relative cumulative outperformance relative to bonds since the recovery began. Often, when investor economic confidence is shaky—as it was most of the time during 2010 and 2011—bonds tend to outpace stocks. Rising confidence in the future is clearly illustrated by stocks nearing a new relative performance high for this recovery.

Repaired investor confidence is also portrayed by the largest and most sustained positive equity mutual fund net new cash flows of the recovery (Chart 3). Investors are not yet leaving the bond market, but confidence has improved enough to finally get them to begin returning to the stock market. Not only are recent stock mutual fund flows the best of the entire recovery but it has been almost two years since we have experienced anything but stock market redemptions.

Chart 4 shows investor margin balances almost reached an all-time record high in March! Indeed, most of the recovery in margin accounts has occurred since stocks began rallying last fall. Finally, a recent resurgence in IPO activity (not illustrated) is yet another indication that "confidence" is dominating performance in the stock market.

Chart 1
S&P 500 Price Earnings Mulitple*
*Based on Trailing 12-month earnings per share

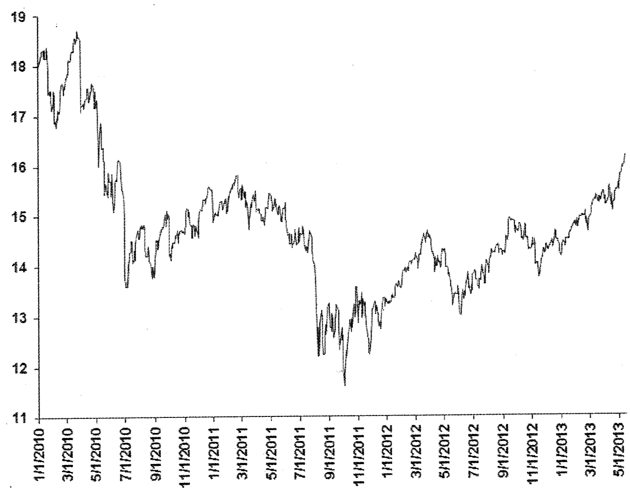


Chart 2
U.S. Stocks vs. U.S. Treasury Bonds
Relative Total Return

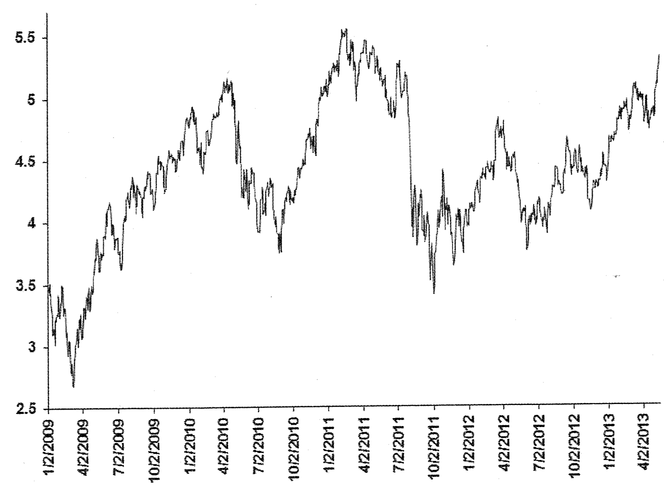


Chart 3
ICI Total Equity Estimated
Weekly Net New Cash Flow*
*Rolling 13-Week Average in Billions of U.S. Dollars

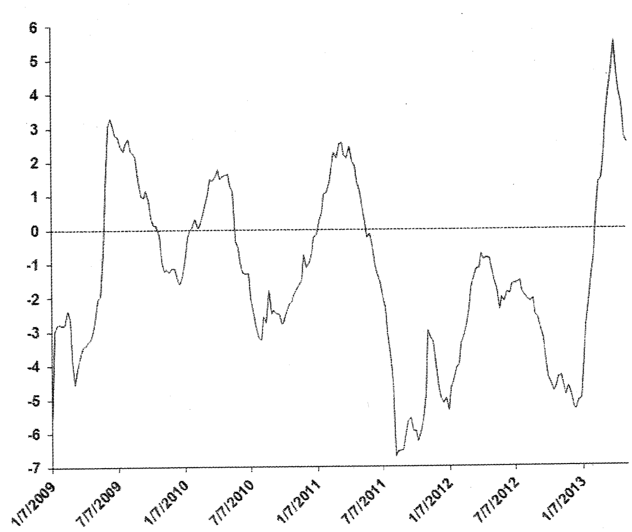
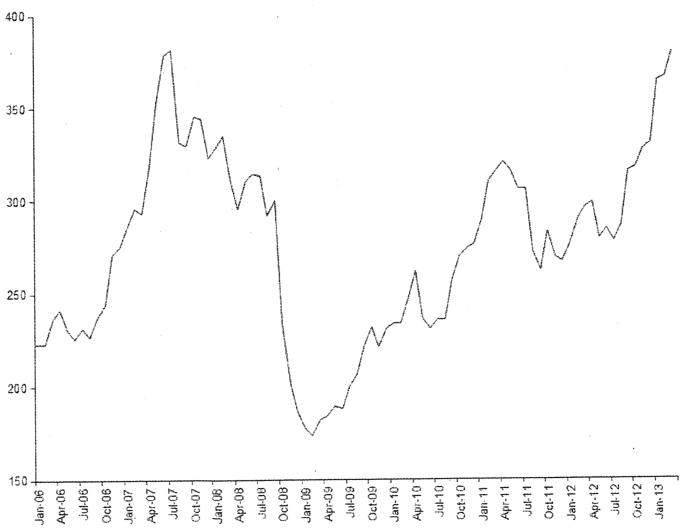


Chart 4
NYSE Member Firms
Debit Balances in Margin Accounts*
***In Billions of U.S. Dollars**



Confidence also extending to other investment markets

The improvement in investor confidence is not limited to the stock market. Chart 5 illustrates the revival in economic confidence is also running through the gold market. Just as rising investor confidence drives the valuation of equities higher, it is also eliminating the "Armageddon premium" which was embedded in the price of gold since the 2008 crisis. Renewed confidence is also evident among junk bond investors. Chart 6 shows that fear, as registered by junk bond yield spreads, has recently declined to its lowest level of the recovery.

Even though the eurozone crisis continues, investor fears surrounding its ultimate impact have lessened considerably. The region remains in a recession but as illustrated in Chart 7, investors now demand only about an 8% yield on Greece government bonds compared to almost a 40% yield in early 2012! European fiscal problems remain and a regional recession persists but investor sensitivity to these problems has calmed as the perception of the eurozone crisis has moved from calamity to chronic problem.

Finally, as shown in Chart 8, despite weakness in overall commodity prices this year, those commodities most closely tied to global economic performance—industrial commodity prices—remain near their highest levels since mid-2011. Most of the weakness in commodity prices has been due to non-economic reasons (e.g., weather normalization for agricultural prices and a reduced safe-haven premium for precious metals). As Chart 8 shows, industrial commodity prices which are driven by and tied to economic confidence remain fairly strong.

Chart 5
Gold Price

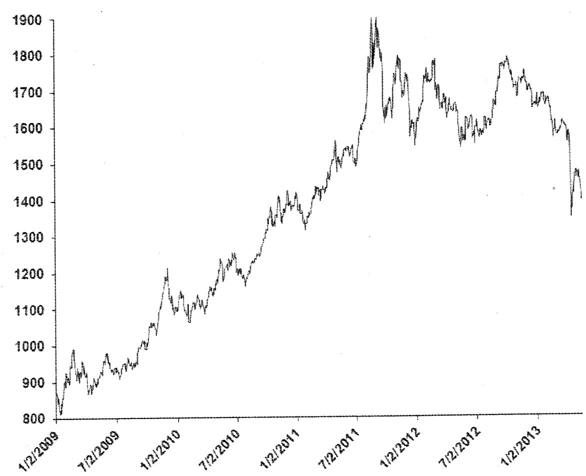


Chart 6
Chase High Yield B Bond Yield Spread

Chart 7
Greece 10-Year Government Bond Yield

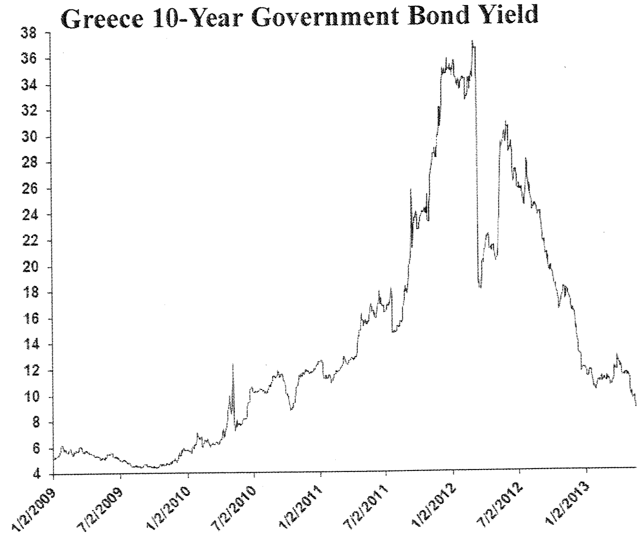
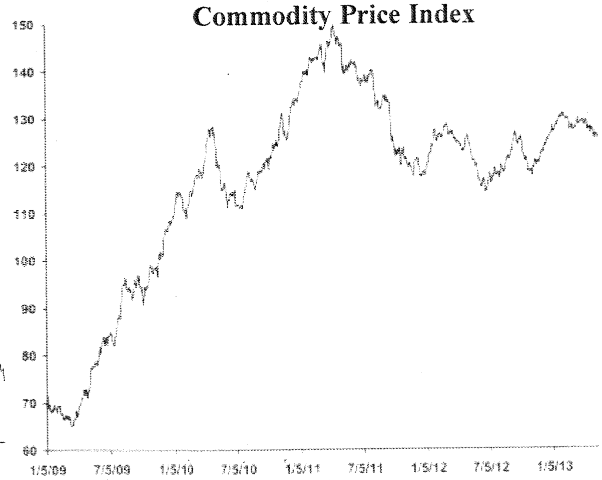


Chart 8
JOC–ECRI INDUSTRIAL
Commodity Price Index



Won't confidence also run through the bond market?

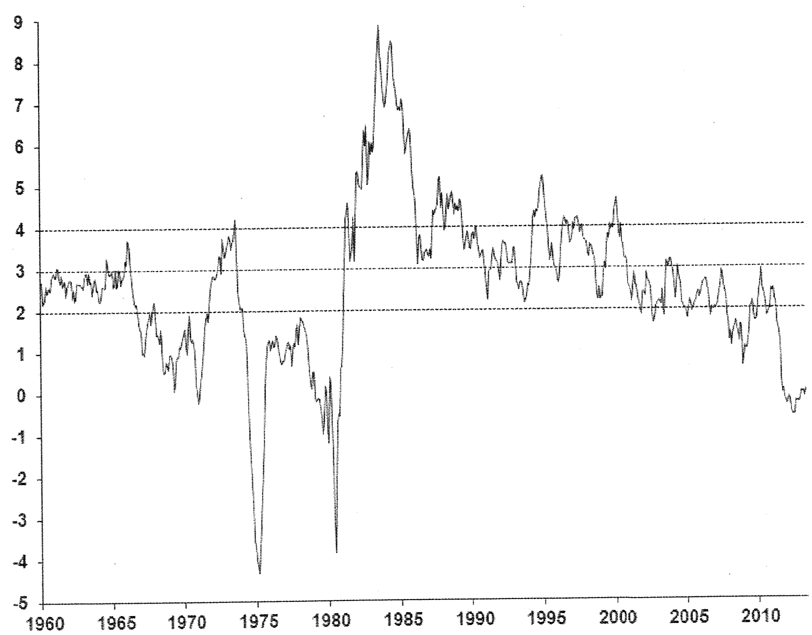
The impact of rising investor confidence is increasingly dominating the performance of the financial markets—except for the U.S. bond market. This may be about to change.

Historically, as shown in Chart 9, the 10-year U.S. Treasury bond yield is typically between 2% and 4% above the annual rate of core consumer price inflation. When the yield has moved significantly outside of this range, it has subsequently proved to be mispriced. For example, bond yields remained far too low in the late 1960s and this was eventually corrected in the early 1970s. Similarly, relative to inflation, yields were again too low in the late 1970s but the surge in yields by the early 1980s corrected this mispricing. Finally, the abnormally high yields evident in the early 1980s eventually led to a three decade bull market in bonds.

Today, bond yields are nearly equal with the rate of inflation and are therefore at least 2% below their normal historic valuation range (shown by the dotted lines in Chart 9). Based on the current core inflation rate of about 2%, a fairly priced 10-year Treasury bond yield should reside between 4% to 6%.

Calling for the end of the great bond bull has not been a successful investment call for some time. However, with improved investor confidence recently dominating the performance of stocks, gold, junk bonds, industrial commodities, and European investments, we think investors should prepare for an eventual "run of confidence" in the bond market. Obviously, the bond bull of recent years has been built on fear and confidence will be no friend for Treasury bond yields. A more difficult question, however, is what will be the impact of a sustained rise in bond yields on the stock market?

Chart 9
Real 10-Year Treasury Bond Yield*
*10-Year Bond Yield Less Core CPI Inflation Rate



What's a stock investor to do if confidence runs through the bond market?

Since last year-end, we have suggested the S&P 500 could touch 1700 this year. We felt economic growth would prove stronger than most expected boosting investor confidence and leading to rising PE valuations. Currently, the stock market is closing in on this target and while we still expect the stock market to breach the 1700 level in the next few months, we also anticipate a tougher environment for stocks during the last half of the year. As it has with other financial markets, rising confidence is also likely to soon run through the bond market perhaps pushing the 10-year yield closer to 3% before the year is over.

We do not expect any big selloff in stocks this year. The negative impact of rising yields will likely be tempered by economic growth which proves stronger than most now anticipate. Real GDP growth in the current quarter may be only slightly above 2%, but we continue to anticipate real GDP growth averaging 3% or more in the second half of this year. Better-than-expected growth and rising bond yields may simply produce a sideways trending stock market in the second half. That is, the stock market may experience a refreshing "correction by time." A period of sideways oscillation which checks excessive optimism, improves valuations (as earnings rise while stocks are flat), and allows the stock market to adjust and assimilate to a revaluation (i.e., higher yields) in the bond market.

We also expect the combination of better-than-expected U.S. growth (despite fiscal tightening) and rising bond yields to intensify pressure on the Federal Reserve to end or at the very least significantly taper its quantitative easing (QE) operations. Ultimately, "normalizing monetary policy" is a good thing which, in our view, will eventually boost private sector confidence. However, investors and equity traders may have some consternation in the short-run with such a sudden change in public policy.

Since we do not expect any big decline in stocks this year, we would not recommend significant allocations away from the stock market. Where are you going to go? Bonds? Cash? Hardly! We are, however, focused on a couple investment strategies for the second half of this year. First, the most important impact of rising bond yields is what it may do to sector performances within the stock market. Charts 10 and 11 examine the relative total return performances for the 10 sectors of the S&P 500 Index, for small cap stocks and for high dividend stocks during those periods historically when bond yields have increased. Both since 1990 and also during just the contemporary recovery, cyclicals have clearly performed the best and defensive and interest-sensitive stocks the worst when bond yields rise. While this is not a surprising result, it is a good reminder of what may happen if confidence takes over the bond market. Interestingly, high dividend stocks (those often considered the most yield sensitive) have not historically been the worst relative performer when bond yields rise. Consumer staples, utilities, and healthcare stocks have tended to underperform the most. Also somewhat surprising is that financial stocks, even though widely considered highly yield sensitive, have actually outperformed historically when bond yields increase. If bond yields do begin rising in the second half of this year, sector reallocations may be the best way to prepare your portfolio.

Second, we anticipate a weaker U.S. dollar during the last half of this year. A strong dollar is currently a popular forecast primarily because it has been so strong so far this year. However, we think developed world countries will simply not tolerate Japan continuing to devalue its yen. We also suspect the Euro will strengthen mildly in the second half as "green shoots" on economic growth emerge in some parts of the eurozone. Finally, many believe the dollar will strengthen as the Fed winds down its QE program. Our guess is the U.S. dollar may actually weaken because although excess bank reserves may decline, the growth rate in the U.S. money supply may actually accelerate in the second half due to a lagged response from previous easing moves. In lieu of a weaker U.S. dollar, investors may want to consider increasing overseas exposures and also raising allocations to commodity investments.

Chart 10
Annualized Relative (to S&P 500 Index) Total Return Performance Since 1990 for All Weeks When the 10-Year Treasury Bond Yield Rose

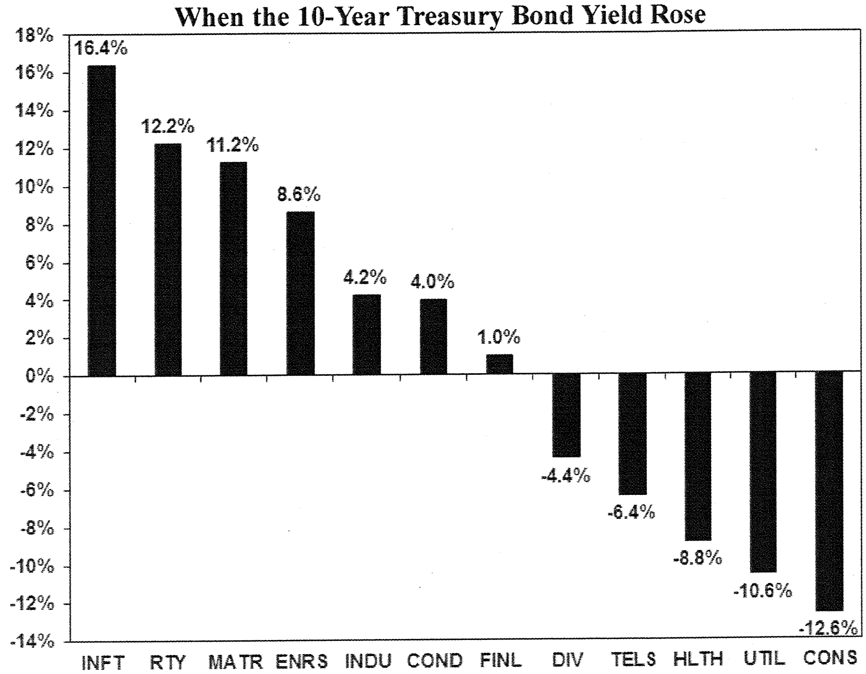
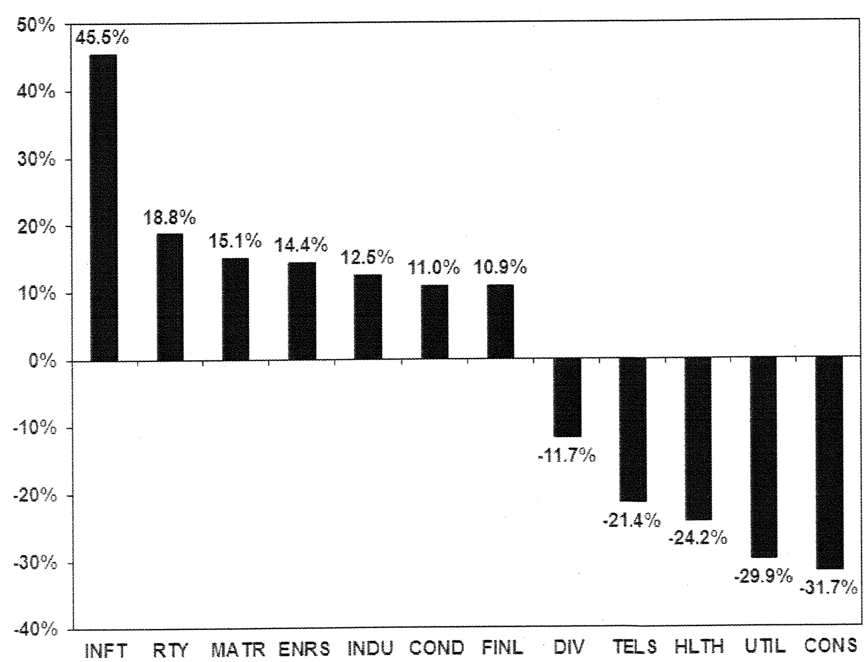


Chart 11
Annualized Relative (to S&P 500 Index) Total Return Performance Since 2009 for All Weeks When the 10-Year Treasury Bond Yield Rose



INFT: S&P 500 Technology Sector
RTY: Russell 2000 Small Cap Index
MATR: S&P 500 Materials Sector
ENRS: S&P 500 Energy Sector

INDU: S&P 500 Industrials Sector
COND: S&P 500 Consumer Discretionary Sector
FINL: S&P 500 Financials Sector
DIV: S&P 500 Dividend Aristocrats Index

TELS: S&P 500 Communications Sector
HLTH: S&P 500 Healthcare Sector
UTIL: S&P 500 Utilities Sector
CONS: S&P 500 Consumer Staples Sector

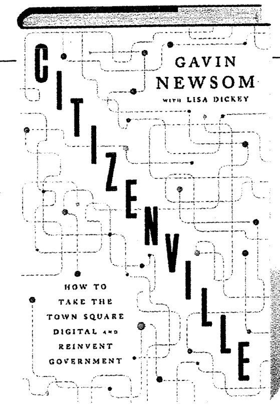
Is this another "buy & hold" era?

The elements for a longer-term "buy and hold" stock market era are emerging. The biggest long-term risk for both the longevity of this economic cycle and for the continuation of this bull market is inflation. If, because of unprecedented and massive monetary easing in almost every corner of the globe, inflationary pressures eventually surge out of control both the economic recovery and the bull market will be prematurely ended as policy officials and bond vigilantes are forced to shut down inflationary forces.

However, should inflation remain moderate, the odds favor a very long economic recovery and eventually a much higher stock market. Why is it likely to be a long recovery? Because confidence was so thoroughly and utterly destroyed in the 2008 crisis! Recessions are primarily caused by over-confidence. It is excessive confidence which causes private economic players, investors and policy officials to do dumb things which lead to the next recession. When people get comfortable and then confident, they overuse credit cards, buy the second lake home, blow through their savings, and over-invest in risky stock market assets. Likewise confident businesses overstaff, over-inventory, and over-build to take advantage of the profitable future they are sure is coming. Finally, only when policy officials are more worried about over-heating than under-heating do they tighten enough to produce a recession. Today, despite being in the fourth year of this recovery, the attitudes of the players reflect a young recovery. The economy is currently being run by a bunch of "church mice" hunkered down and fully prepared for the Armageddon everyone tells them is coming. Households have reduced debt service burdens to record lows while fully restoring their net worths. Everyone is highly liquid, nobody is overpaying for houses and they certainly are not over-invested in the stock market. Businesses have considerable dry powder and lean staffs despite surging profits. Finally, the Fed is still employing full throttle crisis-like policies and tightening seems a long way off.

While confidence is finally beginning to improve, its recovery is still in its infancy and it will likely take several years before confidence reaches the level of cockiness required to produce the excesses which will bring the next recession. In the meantime, while managing the short-term ebbs and flows of the stock market, do not forget the likelihood we are still early in this bull market.

Thanks for taking a Look!!
Jim



Inviting Citizens to the Digital Town Square

IN HIS NEW BOOK "Citizenville," California Lt. Gov. Gavin Newsom explores how everyday citizens can influence their governments through technology. Newsom, a former San Francisco mayor, is widely believed to be a potential gubernatorial candidate. Here's a condensed and edited interview with Newsom.

—Ryan Holeywell

At what point did you realize there was a whole book to be written about this topic?

[Internet media pioneer] Tim O'Reilly and other leaders came to us and said, "Let's get these data sets online, let's see if we can open up a city app store." They encouraged us to take the open data executive order [from President Obama in early 2009] and take it locally in San Francisco. I remember sitting in my first department head meeting. I wish I could have recorded it. Without exception, every one of my department heads looked at me like, "What the hell is this?"

A few months went by, and only two or three of them took me up on it. The first data sets that went up were from the Department of Environment on recycling centers. The app was called EcoFinder. It was a simple way to find your local recycling center and it showed how to recycle and compost. It triggered my passion. It was like a bright light went off.

Can open government succeed if elected officials don't embrace it?

Even in cities that pride themselves on being open and transparent like San Francisco, it's still an excruciating challenge. If you want to move the mouse, you've got to move the cheese. You've got to change the incentives. Our attitude in the past has, by default, been secrecy and closed systems. The default has got to be openness and active citizen engagement.

We have to govern like we campaign. We're very good at trying to engage in two-way conversations when we campaign, and when we get into office we tend to go back into a broadcast model: You vote and I decide. That's not working for folks anymore. The principles of the campaign—organization, bottom-up thinking, volunteering, engagement—those principles can't end on Election Day. We've got to recognize that top-down, hierarchical thinking, let alone governance, is not relevant to the world we're living in. You have to engage in conversation. Those traditional town hall meetings just aren't going to cut it anymore.

If you're a more conservative leader, you can look at the opportunity to substantially reduce the costs to taxpayers. You put data sets up in a way for the public and private sector to do things that, in the past, only the government did for them. Then, taking the more progressive framework, this notion of community, conscious engagement and partnership in terms of solving problems has appeal as well. It transcends technology.

What do you want California to do differently when it comes to technology?

We've all had nightmare procurements with IT. It's truly an exception that an IT project proves to be as good as we claim it to be. There's hundreds of millions of dollars wasted, and it's a miracle we get away with it. That's why I wrote the book. I was frustrated by my own inability to convince people at the state level to be aware of it.

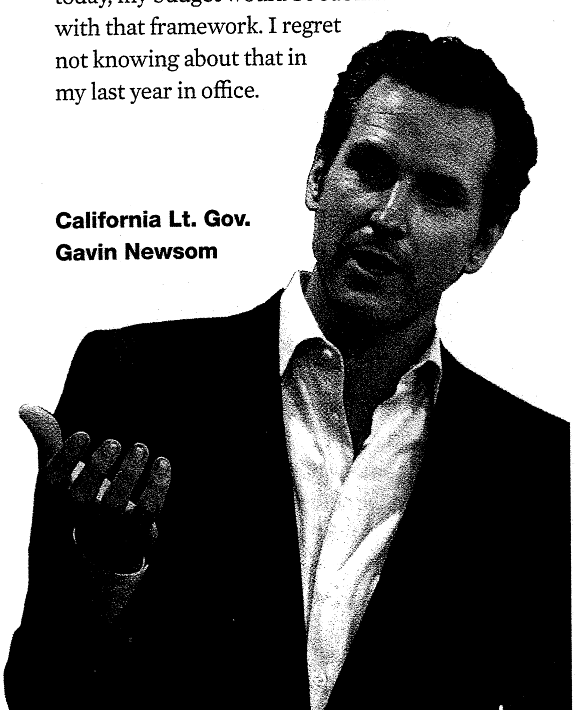
Our secretary of state's office was rightly criticized for taking 60 calendar days to provide a business license in the state. That should take days, not months. The response was that they didn't have the money to hire people, and they are doing a tech upgrade that will be online by 2016. It makes you want to scream. You can go to Silicon Valley right now, and get three or four kids to give you an app that aggregates the system.

It's not just a technology problem. It's an attitude. What I keep telling my colleagues in Sacramento is that it's not about e-government; it's about "we government."

This is the hardest part to change, that old legacy mindset. We all have 1970s-era technology in our cities, and there are one or two guys who know how to work it, and you've got consultants with overtime bills who patch it together, hoping it won't collapse.

What did you learn about while writing your book that you would have implemented in San Francisco if you had known about it?

No. 1, 2 and 3 is participatory budgeting. If I were back in the mayor's office today, my budget would be submitted with that framework. I regret not knowing about that in my last year in office.



California Lt. Gov. Gavin Newsom

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