LUMBARD INVESTMENT COUNSELING

INSIGHT

S&P 500 1,687 * Dow Jones Industrials 15,369 * 30 year U.S. Treasury Bond 3.84%

MOTOWN BLUES

"Addressing a lunchtime rally of more than 6,000 state workers in front of the State House Annex on Monday, [NJ Governor] Corzine pumped his fists and vowed to keep his pledge to increase the pension contributions. "I will fight for you,'' Corzine told the crowd, made up largely of members of several municipal unions."

– The N.Y. Times, explaining that instead of negotiating with his employees—workers who had contributed to his election campaign—Corzine proposed a sales tax increase from 6% to 7%. Buying votes with taxpayer dollars . . . Corzine, who has been sued by the CFTC for losing $1,000,000,000 in customer funds at MF Global, also served as a U.S. senator. And, wouldn't you know it, before all that he was the chairman and CEO of . . . Goldman Sachs.

All over the nation, for decades, politicians have been buying votes by giving special treatment to the unionized public employees who work for them. Payment for re-election was usually purchased with generous retirement benefits, because the bill wouldn't come due for years . . . The worst stories of abuse seem to come from California (which is already paying pensions *larger* than $100,000/year to *twenty thousand* public-sector retirees), but the legal precedents will be set in bankrupt Detroit.

Detroit entered its downward spiral decades ago, when the Big 3 auto makers began to give up great chunks of market share because of dysfunctional and arrogant management, and assembly lines that were snarled in union rules. In the end the management was kicked out, but the unions had enough political power to subvert the bankruptcy process and steal a chunk of GM from the bondholders. And the city of Detroit continued to be snarled by union rules and bureaucracy so severe that its agencies couldn't fire anyone, couldn't get workers to show up for shifts, had to lay out huge sums for overtime, and couldn't stop workers from going out on permanent disability without examination.

Impossible retirement promises have been made at every level of government. In the late 1980s a union-dominated retirement board in Providence, RI, established a 6% annual cost-of-living increase that remains to this day—hugely benefitting a fire chief who served for little more than a year in the early 1990s and retired at 55. He was paid for *not* working throughout the 90s, and now receives more than $200,000 a year. According to WPRI Eyewitness News, if he lives to 89 those 6% raises will push his annual payout to ***$419,781***.

Then there's "spiking". The chief executive of Ventura County, CA, cashed in $69,000 of holiday time and other benefits to fatten up her pay of $228,000 in her last year of work. The last year was all that mattered; her pension was set at $272,000.

How about a double dip? California's Little Hoover

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MOTOWN BLUES

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Commission cited the case of a fire chief who retired in 2009 with a final salary of salary of $185,000. According to The Economist he was able to draw a pension of $241,000 even after he was hired back as a consultant at $176,000 a year.

Very few private sector workers—the people who pay the taxes—now retire in anywhere near the comfort of the public-sector workers who work for them. The best data is for federal workers; in 2010 the average private sector salary was $51,986 (with $10,771 in benefits) while the average federal employee earned $83,679 (with **$42,462** in benefits!).

Federal employment generally demands better educational credentials. But the Bureau of Labor Statistics also offers 2008 statistics for comparable jobs; the private-sector workers averaged $60,046 with $9,882 in benefits, while the federal workers averaged $67,691 with health, pension and other benefits—invulnerable to stock-market crashes—that averaged **$40,785**.

That annual gift of benefits grows and compounds over time. In contrast, Boston College researchers say that the typical household accumulates retirement savings of just $120,000. If you apply the usual 4% "safe withdrawal rate", that's an income of just $4,800 per year. And it's not hard at all to find entrepreneurs—the people we most need to encourage—who emptied out their retirement accounts to make payroll during hard times, and now have little chance of catching up.

The hidden pot of gold is also enjoyed by state and local employees, teachers, paving crews who are unionized by federal law, and employees of the hospitals and universities that now hire lobbyists to ensure a steady flow of federal funding.

"The pension crisis is no longer around the corner. It has arrived at our schools."

–Rahm Emanuel, mayor of Chicago (and former White House Chief of Staff), after laying off 2,100 teachers because of a $400 million increase in teacher pension payments.

So what's going to happen to Detroit? The court handling the bankruptcy will divvy up the losses and pain among bondholders and creditors, who include the city's retirees. The decisions made by the court will set a pattern for municipalities across the nation that are sliding towards bankruptcy, and every other state, city, and hamlet will look closely at its future promises—slashing benefits for new hires and bargaining far harder with existing employees.

There will be crippling strikes in some locations. But the job losses will mostly be confined to the political class. ■

OCTUPLED

It was a tough summer for our benchmark account. The August 31 statement showed a value of $843,374, down from the $850,801 we reported in our last issue. Still, that's a huge increase from its 1990 value of $100,000, and up from the end of 2007, when the account stood at $461,826. If you'd like further information, please call us at 800-Lumbard, or visit our website

www.Lumbard.com

***Our current minimum is $1.5 million*

"There is no jurisdiction of any kind, at any level, at any time in the 30-year history of NAEP that has ever registered such low numbers. They are barely above what one would expect simply by chance, as if the kids simply guessed at the answers."

– Michael Casserly, Director of the Council on Great City Schools, describing the 2009 test scores from the Detroit Public Schools.

FAIRLY VALUED

For years you've been hearing that inflation will be the certain result of the tidal wave of money printed by the Federal Reserve. And yet it never seems to arrive; the economy chugs along, sluggish but steady, interest rates stay low, and the stock market goes up. How can this be?

The answer is unemployment. Inflation just can't get started when there are so many people looking for jobs. Their pain is benefitting almost everybody who has a home mortgage, or invests in the stock and bond markets.

And there's little change in the offing, because sluggish economic recoveries can go on for many years. There are huge numbers of future workers waiting in the wings, no longer counted in the statistics because they're no longer looking. Labor participation is particularly low among the young; young people are extending their education, moving in with Mom and Dad, or disappearing into the "cash only" underground where there are no taxes and no reporting.

After 4 1/2 years of appreciation, stocks are no longer undervalued; but they're not overvalued either. The right way to receive that news is to recognize that this is a *good* time to buy.

It's often said that your investment portfolio should shift towards bonds as you approach retirement, but that makes little sense if you expect to live another 25 or 30 years. It's extremely likely that, over 25 years, stocks will outperform bonds by a dollar amount that's greater than the entire value of your portfolio today. Investing in bonds is a risky bet that you won't outlive your assets. Especially when interest rates are at all-time lows.

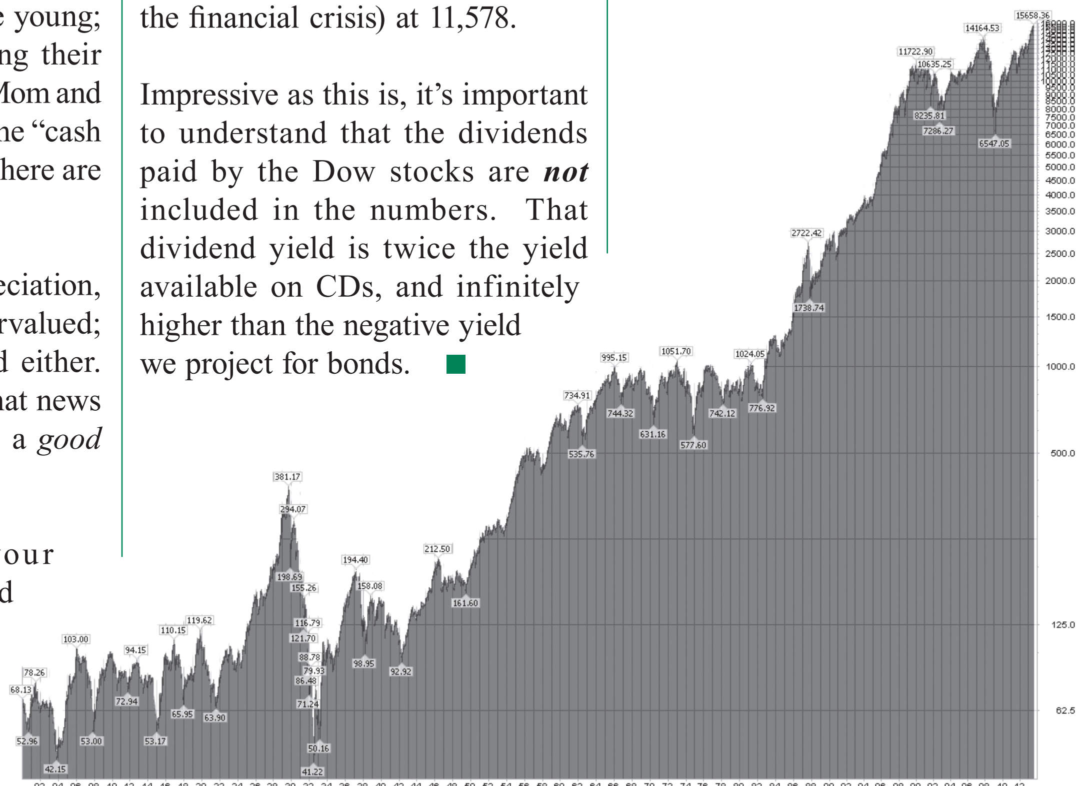
The chart below shows the price appreciation of the Dow Jones Industrials—on a logarithmic scale to flatten it out so it doesn't look like a hockey stick. In 1920 the Dow ended the year at 120. At year-end 1930, a year after the great crash, it stood at 294. Ten long years of the New Deal cut it in half to 140, but the Dow has risen in every decade since.

At the millennial peak—the end of 2000—the Dow stood at 10,788, and it closed 2010 (just two years after the financial crisis) at 11,578.

Impressive as this is, it's important to understand that the dividends paid by the Dow stocks are ***not*** included in the numbers. That dividend yield is twice the yield available on CDs, and infinitely higher than the negative yield we project for bonds. ■

Paul K. Wright, CFA

According to the U.S. Census, the poverty rate for single parents with children in the United States in 2009 was 37.1 percent. The rate for married couples with children was 6.8 percent.



COST EFFECTIVE AND IMPACTFUL

In 2009 the President announced a number of "green" spending initiatives, which included a billion dollars for three companies building lithium-battery plants, an investment in a politically-connected solar-panel manufacturer, and a big loan to Fisker Automotive. Fisker is in a coma; partly because the lithium battery investments caused massive overcapacity that bankrupted A123, an American battery company with good technology. A123's technology was snapped up at a bargain price by a Chinese company . . . Meanwhile, overcapacity in the Chinese solar-panel industry bankrupted the American solar-panel manufacturer.

These were charitable donations made with our money as taxpayers (part of the bill is still ahead, because we borrowed some of the money from China), but we didn't get to choose the recipients of the donations, get a tax deduction, or get any personal satisfaction. Politicians took all the credit for the gifts. This stands in sharp contrast to a gift we just made to a project in India that's supported by a Hollis resident who was born there.

The money will be used to buy inexpensive Chinese solar panels—they've become even cheaper, because of new tariff barriers erected to keep them out of the United States—and place them on the roofs of hostels in India. The hostels house desperately poor girls and boys who were not attending school because they lived too far away, and were doomed to repeat an eternal cycle of poverty and illiteracy.

The program is extraordinarily cost effective and impactful. Our $1,000 will be matched by $2,500 from Rotary International, thus funding *more than half* of a solar panel system that will cover all the basic power needs of *dozens* of children—in an area where power is so scarce that it is rationed to an hour a day. A picture of the children of the first recipient hostel is below.

A NEW MEXICO

Get this; Mexico is now *the least expensive place in the whole wide world to build a car.* There are now 25 car-assembly plants in northern and central Mexico, and they'll soon be joined by new Nissan and Honda facilities. There are 1100 firms making car parts . . . Rapid wage increases in China have pushed that nation's manufacturing costs above those in Mexico, and almost to 90% of U.S. levels.

Mexicans work hard, and their manufacturing infrastructure is growing rapidly. Especially in autos, because the nation's schools and universities have long had a focus on automotive engineering.

That's not all. The new president of Mexico, Enrique Peña Nieto, is battling billionaires to open up the nation's telecommunications industry, and battling drug lords and a bad-behaving teacher's union. He wants to reform the tax system, give small businessmen access to credit so that they can create jobs, and change the constitution to allow companies other than sclerotic Pemex to explore for oil and gas in Mexico's vast shale holdings.

It's a spectacularly ambitious agenda, because Mexico's entrenched interests are no different from ours. Success could elevate millions of people from poverty, but the gains will develop slowly and require faith. ■

"It is much more important to kill bad bills than to pass good ones."
– Calvin Coolidge

RED TAPE

"Over the past 15 years I've started small ventures in both the U.S. and the U.K. In the process I've learned something surprising: it's much easier to do in the U.K. There seemed to be more regulation in the U.S., not least the headache of sorting out health insurance for my employees. And there were certainly more billable hours from lawyers."

– Harvard Professor
Niall Ferguson

If you've re-financed a mortgage in the last few years, you know that the slender little packet of disclosures and agreements of the 1980s and 90s has metastasized into a 100 page lump of despair. If you feel any compassion for the closing agent you'll listen to her quick descriptions—"this one says that it's OK to sell your mortgage to the People's Bank of China, and this one says you have a right to privacy except in cases where your lender wants to know something about you . . ."—and then sign them without reading.

Like our tax system, it's a huge waste of paper, time, and money. H&R Block now claims that it has "110,000 tax pros receiving over 10 million hours of tax training each year".

This iceberg is slowly sinking our titanic economy. In our last issue we noted that 1,400 new regulations had been implemented in the prior THREE MONTHS by the federal government alone. State and local red tape is often worse . . . It might *seem* that workers who shuffle paper around are employed, but in the long term they are a cause of unemployment and a barrier to moving people out of poverty.

The Rocky Mountain Institute recently compared the cost of installing solar panels in the U.S. and Germany: "Local governments typically take about eight weeks in the U.S. to meet all permitting, inspection, and zoning-related requirements for a residential installation . . . In Germany, it can take as little as eight days."

If you've experienced mortgage madness, you're in a position to appreciate the creeping growth of red tape and bureaucracy—warehouses full of paper—that has been slowly burying our corporations. They have entire buildings full of people who do nothing but fill out paperwork for the EPA, OSHA, the FDA, the SEC, the Department of Labor, the IRS, health care bureaucrats, and other regulators. If that sounds like a good way to get people employed, you've never had this elephant sit on you.

We've been brushed by that great grey bottom; in the early years of this firm a New Hampshire regulator threatened to shut us down, apparently just to see how we'd react. Nothing actually came of the exchange, but the sleepless nights left an enduring impression. It was a tiny taste of the pressure that many entrepreneurs feel.

It's a wonder that we ever create any new jobs at all. ■

Drew D. Kellner, CFA

Big Oil has a problem. Their reservoirs deplete year after year, and they can't grow unless they find *more* new oil than they pump. That doesn't seem so daunting for a midsized company like Chesapeake, riding the shale-oil boom, but the behemoths are almost too large to participate. Exxon's reserves will shrink if it can't find 1.6 billion barrels every year; that means huge projects, but much of the world is closed to them because so many oil-producing countries have nationalized their energy industries.

The result will be a surge of investment in deep and shallow-water drilling in the Arctic, off East and West Africa, and elsewhere in our incomprehensibly-large oceans. It's a boom that will benefit Seadrill, a holding that has already done very well for us. And the boom will put downward pressure on the price of oil, a good thing for our holdings of FedEx, Hawaiian Holdings, and an oil-short fund that we've owned for longer than we planned.

THE DECLINE OF MEN

More women than men now receive college degrees in the United States—***50% more***—despite the fact that there are 800,000 more men than women aged 18-24. This is a clear statement that men are so much less competent in the workplace than women that we should invest significantly less in their education.

Yes, it's the result of deteriorating trends in grades 1-12, where changes in schooling and in society have harmed boys. And yes, more men than women opt to skip college in favor of taking jobs in the trades, but it's still clear that our educational system serves girls better than it serves boys.

Those jobs in the trades—politicians call them "good paying jobs"—are disappearing. First it was construction (we're not going back to building two million homes a year), and now there's trouble ahead for auto workers, truck drivers, and millions of other well-paid (and mostly male) workers. "Well paid" is the same thing as "expensive", and it suddenly makes sense to replace a huge number of workers with robots, or with 3D printers that can print out complex parts for jet engines from a design stored in a PC. Rio Tinto now has a fleet of trucks *without drivers* operating in an Australian mine.

Technical schools are part of the answer—it's said that hundreds of thousands of jobs are going unfilled, because companies can't find qualified workers—but we're going to have to create more college places for boys, and change our primary and secondary schools (and toughen up our parenting) to get them there.

Boys mature later, their verbal skills lag, and their interest in academics is frequently dormant until the college years. Boys need recess—a concept which has nearly disappeared—and discipline, and physical activity interspersed through the day. More than girls, they suffer from changing mores and the distractions of modern life.

But it's not that boys are less intelligent. In 2012, despite declining grades and attentiveness, and slower development of their testosterone-addled brains, their SAT scores outperformed those of girls by 1511 to 1486. The average gap has been 45 points. And no one is actually *saying* that men underperform women in the workplace; we're just investing as if they do.

Students don't go to college to do well in college, but to do well in life. When colleges focus on high school grades rather than the student's ability to perform in an intellectually-demanding future job, they discriminate massively against men.

There's more at stake than fairness, or the lower living standards of boys who matured too late to catch the train to prosperity. The Bureau of Labor Statistics says that 70%

John Lumbard, CFA

of men are working, compared to 58% of women, despite the fact that men took a much harder hit in the last recession. More men work, they work for more years, and they always will—if for no reason other than child-rearing. Women also choose to retire two years earlier.

Society gets a bigger bang for the buck—1.2 times as great—when it invests in educating men. Underinvestment causes a reduction in GDP growth, and even a small reduction means higher unemployment. The effects compound over time to greater poverty and lower living standards—food, housing, and medical care—for everybody, and not just for the under-educated men.

If we can get boys and men back on track, you won't have to worry about the near-term pain caused by the latest wave of innovation. We just need to ensure that we're keeping all the innovators in the game, and that they all have the educational tools they need to improve the lives of people all 'round the world. ■

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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