

## Boenning Morning Comment

*This report is prepared for us by Tower Bridge Advisors*

April 12, 2010

Stocks staged a solid rally on Friday with the Dow Jones Industrials briefly crossing the 11000 barrier before pulling back slightly at the close. The reason for the market's strength was simple; good fundamentals. Earnings season gets started tonight after the close when Alcoa (AA-\$14) reports. Alcoa's outlook is almost always iffy. As a commodity producer, its fortunes are tied to the price of aluminum. Alcoa is expected to show a first quarter profit versus a loss last year but it is not sharing in the same robust recovery that others like Intel (INTC-\$22#\*), which reports tomorrow evening, are experiencing. As always we will be keying in on market reaction to these early reporting companies rather than the actual numbers.

Since I have talked exhaustively about the pending earnings season over the past few weeks, I thought this morning I would switch gears and talk a moment about regulatory reform. There is little question that a lot went wrong between the middle of the past decade, the start of the recession in late 2007 and the beginning of the recovery last year. There was the sub-prime mortgage mess, gross mistakes made by rating agencies, excessive risk taking and leverage at major banks, even wider risk taking and leverage at the big brokers, flawed securitization, and credit default swap abuse just to name a few. I didn't even mention Fannie Mae and Freddie Mac.

In Washington, particularly with Democrats in control of both the White House and Congress, there is an instinctive reaction to pass new legislation to fixed yesterday's problems.

But there are several problems with this approach:

1. Yesterday's problems may not be tomorrow's problems. Will whatever legislation that passes deal with future problems or will it simply cure what happened before and may never happen again?
2. Will the costs be prohibitive and make our financial industry less competitive worldwide?
3. Will it have teeth or will it simply be a framework without a true enforcement mechanism?
4. Will it get to the root of the problem at all?

Before attempting to answer these questions, let me step back and recognize a few basic facts.

1. Banks are cautious during recessions and shortly thereafter. They lend foolishly in boom times. Sub-prime mortgage lending became a problem as banks strove to raise loans outstanding by 10% in an economy nominally growing at a 5% rate. Since every bank can't gain market share at the same time, the obvious solution is to make more loans that contain higher risks. This cycle has occurred time and time again and nothing will prevent that behavior psychologically. To prevent the behavior, regulation must mandate balance sheet limitations (capital ratios, reserve requirements, etc.)
2. Laws and regulatory framework are meaningless if government isn't willing for fund enforcement. Many agencies, like the SEC, were woefully underfunded over the last decade by administrations who believe that markets could self-regulate even though time and time again that premise has been proven wrong.
3. There are already massive layers of oversight and organizations already established to do the regulation. They failed. OFHEO was established in the early 1990s with the sole mission of overseeing Fannie Mae and

Freddie Mac. Yet over the past decade, years before their collapse, both produced financial statements so incoherent that independent auditors couldn't certify them. Both exceeded leverage limits. Both were pressed by Congress and the White House to fulfill a dream of every American living in his own home, a mandate that never made any economic sense. Both spend tens of millions of dollars lobbying (that's legal bribery as far as some are concerned) OFHEO and members of Congress to get their way. In short, oversight was a sham and, as a result, we the taxpayers are spending \$100+ billion we didn't expect to spend. Christopher Cox, then Chairman of the SEC proclaimed within a week of collapse that both Bear Stearns and Lehman Brothers were in solid shape. To this day, even in hindsight, he has shown no understanding of what was happening under his watch. The SEC was handed an almost complete dossier on Bernie Madoff more than once and still let his Ponzi scheme get totally out of hand. No funds for enforcement; no enforcement.

4. Shadow markets created the most damage. These include non-bank mortgage lenders, creators of credit default swaps, and over-the-counter trading in commodity futures. The problem is just as bad today as it was three years ago but when markets are going up, the pain dissipates and many feel the problems have been solved.
5. Creators of toxic assets for the most part are not required to retain any contingent liability.
6. Buyers of credit default swaps do not have to have any insurable interest.
7. Risk taking and risk aversion are allowed to intermingle.
8. Rating agencies are still paid by the entities they rate.

Legislation pending in Congress remedies some of these faults but not all of them and until final rules are passed, if indeed anything at all passes, we won't know whether we are better equipped to avoid problems going forward than we were the last time. But this much we know. Basic human psychology isn't going to change. To prevent human behavior from creating economic disaster, rules need to be in place that punish abuse adequately. Bankers that create securitized pools must retain some form of contingent liability or they will forever sell heaps of manure at such times as there are sufficient buyers. If you allow an investor to bet on the failure of an enterprise, you must believe he will do everything in his legal power to insure that the given enterprise fails. That is why buying credit default swaps to protect is so very different than buying credit default swaps to speculate. And isn't it equally logical that the last entity that should be paying the rating agency is the entity being rated?

Any legislation needs to define a security in its broadest sense and then establish a framework for trading, reporting and regulation. Fantasy football is a wonderful activity but it doesn't interfere with real football. Unregulated and uncontrolled over-the-counter trading in oil futures clearly impacts the real world. I don't mind financial players speculating in these markets as long as (1) I know whose capital is at risk and (2) I can gauge how much speculation is taking place. The oil market bubble in mid-2008 is a perfect case in point. We still don't know what took place then and how manipulative trading was if indeed it was manipulative at all.

At a minimum, regulation must do the following:

1. It needs to broadly define a security and set requirements including clear reporting and capital requirements.
2. Derivative asset creators must retain a certain contingent liability under outlier circumstances.
3. Risk taking and risk aversion have to be separated in certain circumstances or capital requirements have to be raised and enforced to protect those markets that need to be protected from risk.
4. Rule based systems must be established that protect investors and the general public. Higher capital ratios for banks, for instance, will protect against some level of abuse.
5. One must assume that not all future administrations will embrace enforcement with the same zeal. Rules must be set to guarantee a minimum level of safety and enforcement at all times.

6. No new regulations should be established if there are already current rules in place that simply failed for lack of enforcement.

In addition, we must understand the following:

1. There are and will always be banks that are too big to fail. But that doesn't and shouldn't save shareholders in those banks.
2. Fannie Mae and Freddie Mac have long outgrown their usefulness. The government should find an exit strategy to get out of that business. That will be Wednesday's topic.
3. Without proper safeguards, what happened in 2008 can and almost certainly will happen again.

Futures point to a slightly lower opening.

Today David Letterman is 63.

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Additional information is available upon request.

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