INVESTMENT PERSPECTIVES
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BROWN ADVISORY

SKIN DEEP?

While the equity markets gradually climb the proverbial "wall of worry," recent concern over the solvency of several members of the European Union has once again highlighted the fragility of the global recovery. Until relatively recently, the principal focus of default risk was on financial institutions and a number of industrial companies, as they faced the potentially deadly combination of high leverage and a deep recession. But now, thanks in large part to government bailouts and stimulus programs, companies appear to be heading down the road to recovery while attention has turned to governments as a potential source of financial instability.

It should not be surprising that the very institutions responsible for the rescue of their respective economies and private enterprises are increasingly under pressure themselves. Since these governments already had significant debt burdens before the recession began and only took on more debt in order to help the private sector, they are, in a sense, left holding the bag while the private sector begins to recover. As sovereigns absorb a greater proportion of the credit risk around the globe, their credit standing is beginning to look more and more like those of the markets they support. Bill Gross of PIMCO put it this way: "The Kings…, in the process of increasingly shedding their clothes, begin to look more and more like their subjects. Kings and serfs begin to share the same castle."

Greece and Argentina

The recent furor over Greece's possible default is the latest, but certainly not the last, case in point. Torn by corruption and a vast underground economy, Greece has long been a relatively weak member of the EU, but the recession has exacerbated these problems and the country has been seriously challenged in its attempt to roll over $27 billion of debt coming due in the next two months. Its government has introduced significant austerity programs, including freezing pensions and cutting civil servants' pay, only to be confronted with widespread strikes and intermittent violence. The situation reminds us of Argentina's circumstances nearly 10 years ago, when a four-year recession coupled with the necessity for austerity to preserve its credit standing also resulted in strikes and civil unrest. In Argentina's case, even after receiving emergency funds from the International Monetary Fund in 2001, the country defaulted on $155 billion of international debt.

The two cases are quite different, of course, in terms of the countries' resources, institutions and potential sources of support. Most importantly, Greece's membership in the EU and its currency tie with the other member countries provide it with a natural support group that Argentina never had. It also means that unilateral devaluation — Argentina's ultimate way out — is not an option. In the long-term scheme of things, Argentina's problems made little difference in the global economy or even the capital markets, and Greece's issues may not matter much either. Even so, it will be interesting to observe how Greece's dilemma is resolved and whether the contagion spreads to other weak nations.

From a personal perspective, we find it distressing to see countries like Greece and Argentina in such dire straits. Both are blessed with wonderful cultures, interesting histories, magnetic charm and rare beauty — especially the latter. Each country has a spectacular physical landscape that beckons travelers and artists alike. In terms of humankind, we associate Greece with the idealistic beauty of the classics and Argentina with a unique combination of Latin and European influences. In the harsh light of economic reality, however, that beauty is only skin deep. The degree to which other countries share this paradox remains to be seen.

The Burden of Debt

In the United States, the cost of bailing out parts of the private sector and stimulating the economy has placed a heavy debt burden on the government and indeed the entire country, but so far the markets have been supportive. The yield on 10-year Treasury bonds has held remarkably constant during the last several months. Part of the reason

is that inflation has been kept largely at bay, thanks to high unemployment and the slack in capacity utilization. In addition, the lack of demand for credit in the private sector has provided plenty of room for the government to conduct its financings. U.S. debt securities are still seen as a relatively safe place to invest in a global environment that many investors perceive as risky. Still, the crisis in Greece can be viewed as a kind of warning shot. Even though its problems had festered for a long time, its bonds traded at modest yield spreads to those of, say, Germany, but the sudden awakening of investors to its difficulties drove spreads to record levels and the yield on 10-year Greek bonds reached twice the level of their German equivalents. As national governments around the world attempt to raise some $4.5 trillion in new funds this year, investors in sovereign bonds are undoubtedly more sensitive to the risk that nations have taken on as a result of the Great Recession.

While it may be argued, as Niall Ferguson of the *Financial Times* did in February, that the U.S. is heading down the same path as Greece, we don't subscribe to that view. The institutions that ultimately have to deal with shouldering our debt burden are very different, and politics have historically played a smaller role in our free-market economy. Nonetheless, it's important to recognize that we face a high hurdle in dealing with the potentially toxic combination of debt and entitlement obligations that ultimately must be extinguished. Federal debt as a percentage of GDP will reach 100% in two years, and the interest cost of this debt alone is likely to exceed defense spending within the decade. While comparisons to Greece can be easily overplayed, it is worth noting that Greece's crisis hit when government debt was about 110% of its economy. A recent paper by Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard suggests that we are close to the point at which debt becomes a significant drag on growth. Based on data from 44 countries over 200 years, the authors calculate that when public debt exceeds 90% of GDP, the median growth rate in GDP falls by a percentage point. Rating agencies are sensitive to these issues, as evidenced by a recent Moody's statement: "Growth alone will not resolve an increasingly complicated debt equation. Preserving debt affordability at levels consistent with Aaa ratings will invariably require fiscal adjustments of a magnitude that, in some cases, will test social cohesion."

As is widely understood, federal debt levels are not the only problem. States, too, have struggled to close widening operating deficits and meet pension and health care obligations. Not long after Chris Christie took office as Governor of New Jersey earlier this year, he addressed the State legislature on budgetary issues, pointing out that the State's *unfunded* pension and medical benefit costs total $90 billion. This amount would require $7 billion a year to bring them current — money the State does not have. He illustrated the problem by citing a retired state employee, age 49, who paid a total of $124,000 toward his pension and health benefits: "What will we pay him? $3.3 million in pension payments over his life and nearly $500,000 for health care benefits — a total of $3.8 million on a $120,000 investment. Is that fair?"

Fair or not, New Jersey's predicament is typical of that faced by the nation as a whole. At the same time as we fight our way out of the recession, we need to get our economic house in order. Recent data indicates that the worst of the cycle is behind us. Manufacturing activity has picked up, inventories are gradually being rebuilt, retail sales have a positive tone, and employment appears to be on the verge of growing again. The challenge confronting policy makers is to transition from promoting the recovery (low taxes, deficit spending) to getting the house in order (higher taxes, surpluses). The prospect of raising taxes and reducing spending is a politician's nightmare, but electoral sentiment appears to favor a shift toward fiscal responsibility and — perhaps — smaller government. Trying to accomplish this when the recovery is so weak is a particularly high-risk proposition, however.

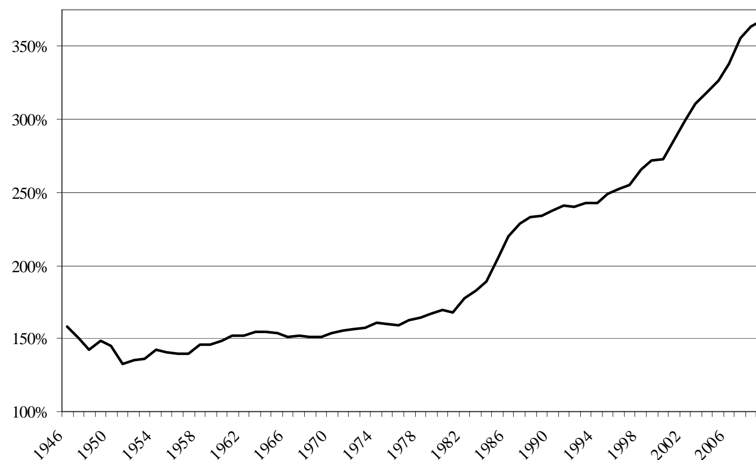
Sluggish Growth and Volatility

The conflicting forces of sustaining the recovery and exercising fiscal responsibility suggest to us that overall growth will remain sluggish for several years and there will be slack in the economy for some time to come. To illustrate, at a rate of 1.25 million new private sector jobs per year (the pace of jobs growth in the late 1990s and twice the rate during the 2001-2007 recovery), it would require seven years to get back to full employment, defined by a 5% unemployment rate. Meanwhile there are the downside risks of bankruptcies, defaults and policy errors that could set the recovery back fairly easily. As one observer said, these uncertainties introduce a substantial "left-hand tail" to the distribution of outcomes even though the mean growth figure is still a positive number.

Much, if not all, of the responsibility for the left-hand tail goes to the long-term growth of credit, or leverage. In this connection, it is noteworthy that the ratio of total debt to GDP in the U.S. has increased from 150% to more than 350% over the last 100 years, and in the first seven years of this decade credit grew five times faster than nominal GDP before reversing course over the last two years. Until leverage comes down, changes in the economy and financial conditions will tend to be magnified through the prism of market prices, and the investment environment is likely to be characterized by a high level of volatility. Certainly, the last two years have been highly volatile — both to the upside and the downside — and we're not suggesting that such wide swings in securities prices will necessarily become the norm. But when leverage is high, a greater level of volatility is inevitable.

In such a scenario, it's especially important to be thoughtful about asset allocation and, we believe, to take advantage of opportunities to earn above-average returns without adding to overall portfolio risk. Despite the run-up in stock prices over the last year, we continue to believe that equities offer more upside potential than bonds, although bonds in the short to intermediate part of the yield curve do provide an important element of stability and liquidity to balanced portfolios. Generally, we would expect bonds to return something less than their current coupons, which of course are woefully thin in the current environment. At the same time, we caution against stretching maturities to gain yield in recognition that inflation could become an issue, forcing interest rates higher, when the economy strengthens and the authorities confront the formidable task of paying down debt. Stocks are still not expensive by historical norms, and earnings estimates continue to edge up as companies exceed profit expectations. Reasonable valuations notwithstanding, a sluggish recovery suggests that earnings growth is likely to lag that of a typical post-recession period, so stocks may produce only "average" returns over the next few years.

Figure 1. U.S. Credit Market Debt as a Percentage of GDP, 1946-2009



SOURCE: Federal Reserve System, Flow of Funds Accounts of the United States

Opportunities

In an environment marked by a laboring economy and the likelihood of continued volatility, we have been particularly active in seeking out additional investment ideas and vehicles to supplement core portfolios, to add to potential returns, reduce risk, or both. Among those on which we have focused are:

- *Emerging markets:* Although more volatile than their developed markets counterparts, the emerging markets present a long-term opportunity for above-average gains. In recent months, we have sent investment teams to India and Brazil to gain a first-hand view of the growth of these markets, and another team will be traveling to China this fall. Developing nations are benefiting from growing demand for their exports, and as they expand their manufacturing capabilities to meet this demand they are accelerating their own process of urbanization and economic development, which is funded heavily by high savings rates. A good example is China, where an average of 20 million people a year have been moving into urban areas, driving demand for housing and other amenities implicit in a higher standard of living. We are participating in these trends through both a "long-only" strategy managed by a leading emerging markets manager in London and a hedge fund-of-funds that we believe offers the potential for capturing most of the upside in emerging markets but with far less volatility.

- *Commodities:* Partly because of the growth of emerging markets, commodities represent an interesting opportunity. China, for example, is not particularly rich in natural resources, so it has to buy on the international market to supply its considerable needs. In addition to profit potential in their own right, commodities offer inflation protection and diversification advantages, as they are relatively non-correlated with bonds and stocks.

- *Real estate:* Real estate partnerships also offer the advantage of long-term inflation protection and low correlation to marketable securities (in part because their stated values don't change with the same frequency). We prefer partnerships as a vehicle over REITs because they can draw on freshly raised capital to invest (and are not saddled with problem legacy properties) and are thus in a position to benefit from today's buyers' market.

- *Credit opportunities:* Because of dislocations in the credit markets stemming from the financial crisis, there have been numerous opportunities to participate in private partnerships and other vehicles formed to take advantage of specific areas of credit. In 2008, we formed vehicles to participate in high-yielding instruments of selected financial institutions and investment-grade corporate bonds, but recently we have begun unwinding these investments as we believe that their outsized potential has been largely fulfilled. Over the last year, we have invested in distressed debt and mezzanine debt partnerships with limited liquidity, and we anticipate investing in an additional partnership focused on the debt securities of technology companies.

- *Private equity:* Although, historically, venture capital and buy-out funds have produced returns well above those of the public equity markets (and the performance of top funds has been better still), funds formed in the current decade have suffered from excess funding, lackluster equity markets and severely limited exit opportunities. We believe the tide may be turning. The industry has been slower to raise money and thus more selective in its investment activities, creating a more attractive (i.e., less competitive) environment for valuations. In addition, the markets for initial public offerings and merger/acquisition transactions are showing signs of life. At the same time, the stretch-out in elapsed time between initial funding and ultimate realizations has created an opportunity to invest in late-stage companies by buying secondary interests from angel investors and senior executives who desire partial liquidity for their long-held positions. We are forming a vehicle to make such investments on a selective basis.

- *Lowering volatility:* Finally, for those clients who seek to reduce market risk but still achieve equity-like returns, we have introduced a vehicle that we call "Counterbalance." In this approach, we create a portfolio consisting of our large-cap growth and value strategies and then sell call options on the Standard & Poor's 100 Index to produce an income stream. Sale of the options limits, but doesn't entirely eliminate, the market risk of the portfolio, and under normal circumstances it produces a 6-10% annualized return by capturing the options' premium for time and volatility. In addition, if the underlying portfolio outperforms the S&P 100 Index, the return is enhanced by the amount of the out-performance.

Having developed these additional alternatives for diversifying portfolios and potentially enhancing returns, we encourage you to speak with your portfolio manager about their applicability in your particular situation.

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