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Foresight

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Greetings!

While we wait together for the flowers of May to fully bloom we are reminded this month that the "reign" of debt is falling all around us. So in this Foresight let's take a pragmatic look at the situation in Europe and one conceptual method to respond to it. Each month I'll share thoughts on various topics in the world of personal finance, investing, economics, and business through my writings below. May you find my musings informative, thought provoking and enjoyable.

Thoughtfully,

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European Debt & The U.S. Markets

Why the crisis has Wall Street stressed about the next potential disaster.

It would be wonderful if the U.S. financial markets could "decouple" themselves from what is going on in Greece, Portugal, Ireland, Italy and Spain. Unfortunately, the debt situation in these countries is like a ripple in a pond. The question is, how strong will the ripple ultimately be and how much will its full force impact our markets?

The problem. Greece, Spain, Portugal, Italy and Ireland are all carrying enormous debts. On May 1, the New York Times put up a chart breaking this down: Greece owes $236 billion, which believe it or not is the smallest debt among these five countries. Portugal's debt stands at $286 billion - and it owes roughly a third of that to Spain. Spain carries around $1.1 trillion in debt, and its economy is in horrible shape (20% unemployment). According to the Bank for International Settlements, it owes $220 billion to France and $238 billion to Germany. Ireland has $867 billion in debt, with about 40% of that owed to the U.K. and Germany. Italy owes $1.4 trillion, including $511 billion to France (almost 20% of France's GDP).(1)

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After the euro was launched, Greece had access to a whole bunch of cheap debt - and the country used it nonchalantly. In the years since the establishment of the euro, Greece's debt-to-GDP ratio has remained repeatedly above 100%.(2). Europe's biggest banks are heavily exposed to these debts, and so are some of ours: names like Citigroup, Bank of America, Goldman Sachs, JPMorgan Chase and Morgan Stanley. In fact, these five banks have $2.5 trillion of cross-border exposure in the crisis, with Citigroup the most exposed. So you have potential risk to these banks, the euro, and the European and world economy.(3)

The offer on the table. Fortunately, Greece has the chance to accept a $146.5 billion bailout from the International Monetary Fund and the European Union in exchange for austerity measures (less government spending and a lower standard of living). This would help Greece avoid default - that is, having to renegotiate its debt and possibly assume more. (As a sovereign nation, Greece cannot go bankrupt.) Many economists think Greece will go into a deep recession (or depression) which could last most of the decade.(2,4)

The potential ripple. It looks like the bailout will be accepted by Greece and its EU partners. This means some confidence will return and other Eurozone nations with big debts will be slightly less threatened. However, Greece still has a risk of default.

Should Greece default even with the bailout, some major lenders in France and Germany would be hit very hard. They would have to raise capital ratios and reduce the frequency of loans. That would hamper economic growth in France, Germany and in turn across Europe. In coming months, the U.S. and other nations could feel the pinch from such a slowdown.(4)

Keep in mind, Greece *only represents about 2%* of the Eurozone economy.(2) In the roughest scenario, Spain (population 47 mil and the world's 9th largest economy) and/or Italy (population 60 mil and the world's 7th largest economy) defaults and the shock wave to European banks and U.S. banks exposed to the debt is significantly greater. What would happen then? A credit freeze across Europe? Diving stocks? Skyrocketing interest rates? Europe bond markets in flux? A trashed euro? A flight to gold? Or How about massive bank failures?

These are merely scenarios, not present realities - but in a nutshell, this is what had Wall Street biting its nails recently.

So is the bailout truly a solution? It was unpopular throughout the EU, but the right step to take if you're the EU and the political will is not there to remove countries that violate the fiscal covenants of the EU charter. The move certainly helped defend the stability of the euro(temporarily) ; in fact, German Chancellor Angela Merkel and French President Nicholas Sarkozy have jointly pledged to preserve the euro's value.(5)

The worry is that other bailouts will be needed to preserve the fiscal health of other Eurozone nations. We all hope these countries can effectively manage their debt levels, for the sake of the global markets, stability of EU countries and the economy in our country.(7)

And now...read on below to learn more about developing strategies in difficult times.

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A Strategy for Volatile Times

"Volatile" is a fancy word that simply means there are enough sudden "ups and downs" in market prices to give an investor motion sickness. As we have once again been reminded during the past two weeks volatility shows us why investors need to plan for the years when the value of their portfolio doesn't just go straight up. And investors need to do it *now*, because volatility, once it becomes apparent, tends to persist for quite a while; that means you are in for a few "interesting" years during your lifetime.

Many believe that the right buffer to erect between your money and a rocky market is simply diversification. Theoretically, if you spread your assets among lots of different asset classes of investments, you reduce the risk that you'll lose a lot of money when some of them lose value in a volatile market. That's how institutional investors approach risk, so it ought to be good for your investments, right?

Wrong as everyone learned painfully in 2008 in an imploding market all investments in all related markets can *all go down together* albeit at different speeds and to different levels. Think about it. There are some crucial differences between you and an institutional investor. One arises as to when you will have to pay taxes on your investment gains. Big institutions, like endowments and pension plans, can invest their money without concern for the effect that taxes will have on their portfolio's growth, because they don't have to pay taxes. You, on the other hand, are subject to taxation on any investments you make outside of any tax-deferred retirement plans you may fund. However, two of the most significant differences between you and the institutional investor is first the time period that each thinks about for its investments -institutions think forever (which by the way is a long, long time), you were advised (by your broker) to look at a long term horizon of 10 years plus; and second the Strategy for diversification.

Seeking Similar Results so Why Different Strategies?

The difference in your tax liability versus institutional tax liability means you need to be mindful of tax implications when making your investment decisions. Yet ask yourself (and consult your tax adviser) if you really should or have been implementing an investment strategy primarily driven by the potential of paying taxes on gains that your investments make. So shouldn't you really seek a Strategy for diversification that first and foremost maintains a portfolio that meets your needs and then addresses the most effective method to deal with taxes?

The financial services industry is beginning to develop new strategies and refine old ones that address individuals' ability to invest more like institutions. One approach that has increasing popularity is called a separately managed account (SMA). Briefly, in an SMA, you place assets with a professional money manager and give that manager the authority to make buy and sell decisions in your portfolio in accordance with your investment strategy. The manager buys securities and holds them in a separate account in your name. This separate account, with its direct ownership of securities by you, is a crucial difference between

SMAs andtraditional mutual funds. An SMA gives you control over when the appreciation (known as a capital gain) is realized through the sale of the appreciated stock. Mutual funds must, by regulation, distribute the capital gains to all shareholders each year, regardless of the effect of that distribution on your tax picture. In an SMA, you can instruct your money manager to orchestrate buy and sell activity to benefit your individual tax situation including selling selected stocks at a loss for your benefit.

There are professional money managers who specialize in managing individually managed accounts using tax-efficient investment strategies, geared deliberately toward maximizing your after-tax return. In an account where the assets are going to compound over a 15-, 20-, 30 or more -year time span, every dollar you keep in the account instead of paying out in taxes during the first several years will make an important contribution to the eventual size of the asset pool.

SMA's and other related Strategic investment portfolios mirror institutional portfolios by direct ownership of stocks, bonds or other assets and by practicing wise diversified asset allocation methods. Although, even diversified institutional portfolios lost money at the end of 2008 and the start of 2009, these same portfolios with some rebalancing were poised to quickly take advantage of a rebounding market and they also did not fall as far as less diversified individual portfolios. Most investors are familiar with Harry Markowitz's published works on Modern Portfolio Theory (MPT) which is the bedrock for the notion of asset allocation or "do not put all your eggs in one basket".

In his paper, Markowitz basically said, "You guys are going about this the wrong way." He first assumed that all investors wanted to avoid risk (which he defined as standard deviation from expected portfolio returns). He then contended that you should measure the risk level of a whole portfolio instead of individual securities. (1) (In other words, if you want to include a security in your portfolio, you should think about how that will alter the risk level of your entire portfolio, rather than simply consider the risk of the security.) MPT asserts that for every portfolio, there exists an "efficient frontier" - an ideal asset allocation among diversified asset classes that should efficiently balance maximum return and minimum risk. (2) Markowitz further developed the theory with economists Merton Miller and William Sharpe, and it eventually won a Nobel Prize in economics. The best institutional investment strategies understand that to control volatility and reduce risk of loss principal in the investment portfolio various alternative investment classes to domestic and foreign stocks and bonds, must be included.

There are never any guarantees when it comes to investment returns, yet I believe that individual investors should consider inclusion of investments like, commodities, metals, real estate, private investments (both debt & equity), and cash/cash like instruments (domestic and foreign) as a component of their total portfolio just like the large institutions successfully do.

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