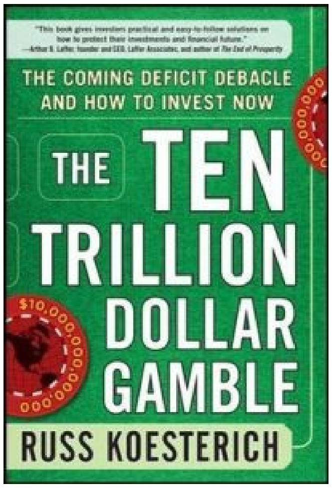

Book The Ten Trillion Dollar Gamble

The Coming Deficit Debacle and How to Invest Now

Russ Koesterich
McGraw-Hill, 2011

Recommendation

A timely book on personal finance with actionable advice is rare, but investment expert Russ Koesterich delivers specific guidance for investors. He jumps into the current debate on the US budget deficit and suggests ways to prepare your portfolio for an uncertain, "deficit-driven" future. Koesterich details which strategies, asset classes and instruments offer potential safe harbors and good returns amid the grim reality of structural deficit economics. *BooksInShort* finds his discussion of the deficit informative and useful, though at times repetitive, and recommends his book to those who are weighing their options for wise actions in financially challenging times.

Take-Aways

- Growing US deficits will trigger higher taxes, greater budget cuts, falling entitlement benefits and increased interest rates.
- In this "deficit-driven" environment, investors will encounter greater stock and bond market volatility, incipient pressure on the US dollar and rising inflation.
- Profitable investing opportunities will still exist, but not necessarily in the same areas nor with the same techniques people used in the past.
- Investment timing is critical: Closely monitor economic indicators for rising interest rates and inflation.
- Lock in your long-term borrowings at current low rates, and keep your cash short term.
- Rising interest rates will lower bond prices, so "ladder" your bond maturities.
- Stocks are in a "secular bear market," which means prices won't appreciate for years.
- Look for equity opportunities overseas, in foreign companies and US exporters.
- Add commodities to your portfolio; they perform well in rising interest rate environments.
- Real estate is a good investment in inflationary times.

Summary

Facing Reality

The US budget deficit in fiscal year 2010 was $1.3 trillion. That amount represents approximately all the debt America amassed from its founding in 1776 until 1984. So, in one year, the country overspent by the equivalent of roughly 200 years of boom, bust and war. Experts predict that between 2010 and 2019, the US will add an annual average of $900 billion to its obligations.

> "The fact that we've gotten away with our financial profligacy in the past does not mean that we will get away with it in the future."

Despite former vice president Richard Cheney's 2002 comment, "Reagan proved that deficits don't matter," the truth is they do matter. While deficits are nothing new in the American economy, these staggering numbers will change the global economic climate and trigger more taxes, greater budget cuts, falling entitlement benefits and increased interest rates. The 2009 and 2010 deficits account for 10% of US GDP, the largest proportion since World War II. Granted, the outsized spending went toward stabilizing a sluggish economy, but the more debt a nation incurs, the higher the chances that it will have destabilizing effects.

> "Investors need to adjust their portfolios to reflect the new economic realities that are coming."

The US's total debt now stands at $14 trillion, an astonishing 90% of GDP. When indebtedness reaches such a high percentage of a nation's output, further government borrowing invariably leads to higher interest rates. As rates rise, inflation threatens, and investors hesitate to buy bonds, because they don't want to lock up their money at low interest rates. So bond prices drop, pushing interest rates up even more. As the deficit grows, the US has to sell more Treasury bonds to finance it, and this new supply of bonds further drives down bond prices.

Investor Beware

In this "deficit-driven" environment, investors will encounter greater stock and bond market volatility, incipient pressure on the dollar, and rising inflation. A stagnant economy will impair people's ability to save and invest. This comes at a precipitous time for many Americans, especially homeowners. Between 2001 and 2008, US mortgage debt doubled, increasing consumer debt to 120% of net income. Personal debt-to-income ratios are at a historic high. An International Monetary Fund study found that interest rates rose more in countries with large national deficits and high personal debt levels than in countries with high deficits but manageable individual debt. Since the US has huge deficits and overextended citizens, higher interest rates will significantly affect the housing market, keeping home prices down and slowing appreciation.

> "The fiscal situation has now reached a point where even if politicians behave responsibly, there are no easy choices."

Higher interest rates make mortgages, car loans, student loans and credit cards more expensive. Inflation also makes the US dollar less attractive to foreign investors. The US economy will likely continue to grow slowly relative to the economies of developing markets. These scenarios hold dangers for private investors, who have little control over such macro issues but need to watch their personal portfolios carefully. Profitable investing opportunities will still exist, but not necessarily in the same areas as in the last few decades, nor will they be accessible with the same techniques used in the past.

It's All About Timing

Timing determines investment success: Moving too quickly into and out of investments can be as costly as reacting too slowly. While the US economy has meandered along for some time, interest rates are not likely to rise until the end of 2011, with inflation following about a year later. In this setting, you should hold fewer US bonds and equities, and more cash and commodities.

> "A long-term rise in inflation is one of the risks that investors need to account for in constructing their portfolios and managing their finances."

To manage your investment timing, watch economic indicators that can foretell the movement of interest rates. For instance, while the government is likely to be a heavy borrower for some time, look for increasing corporate demand for loans. As economic conditions improve, firms will seek credit, and banks' commercial and industrial (C&I) loans will edge upward. Check the Federal Reserve's website every Friday for that week's C&I data. Consumer debt is also critical, because it reflects public sentiment: The better the job market, the more readily people will spend. However, they "are unlikely to start to borrow aggressively again until the debt-to-income ratio is back to around 90%."

> "No matter what, the era of cheap money is over."

Similarly, imminent inflation sends out its own warning signs: Be on the lookout for increased job growth (check monthly Labor Department statistics), rising manufacturing ability (via the "capacity utilization" rate the Federal Reserve reports monthly) and swelling money supply (look for ongoing growth in excess of 6% per year in the Fed's M2 money calculation).

Managing Debt, Cash and Bonds

After a nearly uninterrupted 30-year decline in interest rates, a rising interest rate environment calls for handling your debt and liquidity in a different manner: Lock in your long-term borrowing (such as mortgages) now, while rates are still low, and put your cash only in short-term instruments, so you can reinvest it as rates move upward. Avoid adjustable rate mortgages (ARMs) – your costs go up as interest rates rise – unless you plan to repay your mortgage quickly, before the rate resets. If you're buying a new home or refinancing, consider making less of a down payment or borrowing more. Inflation eats away at what you owe, so you're better off getting a bigger mortgage; you'll owe less in the long run. Keep your cash available in savings accounts, money market funds and one- to two-year certificates of deposit.

> "Munis have one significant advantage over Treasuries or corporate bonds: Unlike the federal government, most states are legally prohibited from running a budget deficit."

Bonds provide income to investors and are usually a safe, secure addition to most portfolios, especially in low-growth economies. Traditional rules of thumb advise most investors to keep about one-third of their holdings in bonds, and suggest more for those nearing retirement. But as interest rates rise, all investors should trim their exposure to bonds, especially US Treasuries.

> "At its root, a structural deficit is as much a political problem as an economic one."

Given a deficit-driven scenario, investors younger than 50 years of age should hold no more than 20% of their portfolios in bonds, while pre-retirees should look to buy dividend-paying and preferred stocks. For the bonds you do hold, "ladder" their maturities: Buy bonds of different durations so when shorter-term bonds mature, you can reinvest in higher-yielding securities. Consider individual municipal (muni) bonds or muni bond funds; keep them geographically dispersed and with durations of less than five years. Prioritize top-rated corporate and international bonds over US Treasuries for your taxable bond portfolio.

The Deficit's Impact on Stocks

Stock investors saw 20% annual returns from 1995 to 2000, but shares in the first decade of the 21st century had their poorest showing since the Great Depression.

The forthcoming scenario of sluggish growth, higher interest rates and creeping inflation all bode badly for future stock performance. Corporate profits will suffer, firms' borrowing costs will rise, and inflation will depress earnings and share prices. A "secular bear market" – a lackluster period, sometimes lasting 10 or more years, with mostly sideways share-price movements – will likely define the deficit-driven future.

> "Smaller deficits, more modest debt, a bond market priced for an inflationary train wreck, and a convenient place for large, developing nations to park their money – this is why the United States has managed to overspend for 40 years with so little damage."

Investors should reduce their exposures to equities, particularly US companies' shares, but they shouldn't eliminate stocks entirely from their portfolios. Be alert to buying opportunities in cheaply valued shares, international companies, inflation-favored industries and uncorrelated investment strategies.

> "Whether you are running a huge hedge fund or managing a small personal portfolio, timing is critical to your success."

Stock markets can post short-term rallies in a secular bear market, but the overall trend is always lower. Determine your risk appetite and your required return on investment. Buy shares of companies in industrialized nations when their price-to-earnings (P/E) ratios drop well below 15 times their annual earnings. These cheaper valuations can turn into good bets, but you should probably not have more than 55% of your overall portfolio in equities. When P/E ratios rise above 20, reduce your equity allocation to about 30%.

> "Just as secular bear markets begin when investors are too optimistic, they end when they're too pessimistic."

Most investors act based upon "home country bias." They feel more comfortable in, and therefore buy too much of, the securities issued by their nation's companies. Because the US represents only one-quarter to one-third of global stock activity, your equities portfolio should be mostly in foreign shares. In the future, certain international and emerging markets will become more attractive for diversification and profit potential, both because they weathered the 2008 financial crisis better than the US, and because they have more promising growth prospects and demographics. For example, Australia and Canada have solid banking systems, less debt than the US relative to their GDPs and abundant natural resources. In inflationary times, the prices of natural resources surge. Emerging markets such as South Korea, South Africa, Taiwan and Chile promise good growth uninhibited by high national debt levels.

> "We should also try to forget the buy-and-hold mantra that was endlessly repeated at the peak of the bull market...Stocks can go down."

Another way to capitalize from the benefits of foreign diversification is to invest in US companies that derive most of their revenues from international sales. American industrial and technology firms tend to have highly profitable overseas operations. For instance, Intel conducted 80% of its sales in foreign markets in 2009. If the dollar weakens, US exporting companies will benefit because their products will then become cheaper in international markets.

> "Even good companies can make for bad stocks if you overpay."

In addition, look for companies in industries that perform well in the face of rising interest rates. The earnings of energy, health care and technology firms tend to withstand inflation better than those of banking, utility and "consumer discretionary" enterprises, like restaurants and retail businesses. Experienced investors should also consider alternative investments such as hedge funds – actively managed and adaptable investment pools.

> "What may eventually save real estate is a bit of inflation. For while higher rates and slower growth hurt real estate, inflation does not."

And when you can't find stocks good enough to invest in, you can always trade market volatility: Price spikes and plunges occur even during sideways markets, so the VIX Index, also known as the "fear index," allows you to speculate on how much the US stock market will swing over a set time period. These positions should only amount to a small portion of your portfolio, but they can provide an interesting – and lucrative – alternative if you do your homework.

"Buy Stuff"

The prices of physical assets, such as commodities and real estate, benefit from rising inflation. While near-term inflation may not yet be in the cards for the US economy, prepare your portfolio for its eventual return. Adding real assets makes a lot of sense, but it also calls for close study and planning.

When inflation first emerges, investors suffer "inflation shock," and their initial impulse is to dump stocks and bonds, and to acquire commodities. Since inflation erodes the buying power of paper assets, commodities become more attractive. In the past, commodity prices have jumped anywhere from 3.8% to almost 10% for every 1% rise in the yearly US inflation rate.

But inflation isn't the only reason to consider commodities for, at a minimum, 10% of your portfolio. Globalization and the growth of newly industrializing countries mean that demand for items like crude oil and metals will surge; concurrently, supplies of these commodities will be under pressure, as nations increasingly deplete their energy supplies and natural resources. Research prospective supply-and-demand data for commodities from emerging users like China and India. Include choices from the whole range of commodity classes: precious metals, energy, agricultural and industrial. Investors seeking portfolio diversification can buy shares of funds based on baskets of commodities or even speculate on prices in the commodities futures markets.

Real Estate

For many people, their only real estate exposure – their homes – may constitute the largest portion of their net worth. In a slow-growth, noninflationary economy, that home is all the real estate you'll want to own. But if inflation roars back, consider investing in a second home, undeveloped land or commercial property, if you hold them for at least a decade and can finance the purchase with borrowed money. Real estate, unlike other physical assets, can potentially provide you with rental income, and it holds its value relatively well over the long term, as long as there is some inflation in the system. Land and housing prices – and their prospects for appreciation – vary greatly by individual markets and type, so consider carefully whether adding real estate to your portfolio makes sense for you.

About the Author

Russ Koesterich is chief investment strategist for iShares and global head of investment strategy for BlackRock Scientific Active Equities.