

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

UNDERSTANDING CREDIT DEFAULT SWAPS

Outside of industry professionals, credit default swaps were an arcane part of the financial market prior to 2007. That all changed when credit default swaps started to garner much more attention due to their role in the financial crisis.

A credit default swap is a contract where one party agrees to pay a fee to receive protection against default and the other party receives that fee in return for providing the protection.

In May 2009, the rate on five-year Greek credit default swaps was 1.5 percent. This means an investor could have bought protection against a Greek default for 1.5 percent per year over the next five years, or \$15,000 per year on \$1 million worth of bonds. In May 2010, the rate had increased to 6.9 percent.

This means the cost of protecting against default had grown from \$15,000 to \$69,000 per year on \$1 million worth of bonds. Another way to interpret this is that the financial markets believed the likelihood of Greece defaulting had increased substantially from 2009 to 2010.

MAKING SENSE OF THE EUROZONE DEBT CRISIS

The Eurozone debt crisis began in earnest in the early part of 2010, and it has become one of the most closely followed financial stories of the past year. What many investors may not realize is the origins of the crisis began well before the financial crisis of 2007–2009.

Origins of the Crisis

Greece was the first European country to enter crisis mode in 2010. The Greek crisis was a confluence of three events:

- 1. A large debt burden prior to the financial crisis of 2007–2009 that grew after the financial crisis hit.** The International Monetary Fund (IMF) reported Greece's debt burden was already larger than its economy in 2005 and 2006. The IMF has estimated Greece's debt burden is currently about 1.5 times larger than its economic output.
- 2. Government budget deficits became untenable.** In 2009, Greece ran a deficit of 12.7 percent of economic output. The only way a country can run a budget deficit (meaning it spends more than it takes in) is by issuing bonds. In early 2009, the rate on Greece's five-year bonds was 4.2 percent. However, beginning in May 2010, it became difficult for Greece to issue bonds at reasonable rates of interest. In that month, the rate on Greece's five-year bonds had risen to roughly 8.2 percent. The credit default swap market profiled in the sidebar also provides insight on how quickly Greece's borrowing costs have escalated.
- 3. The economy was significantly affected by the financial crisis.** In inflation-adjusted terms, Greece saw its economy shrink by more than 2 percent in 2009 and 4.5 percent in 2010, and it is projected to shrink another 3 percent in 2011. This has made it even more difficult for Greece to service its own debts.

Recent Developments

As Greece's debt problem unfolded last year, the IMF and the European Union agreed to loan Greece €110 billion conditional upon Greece implementing significant spending cuts and asset sales. Over the past month, there was tremendous uncertainty as to whether the IMF and the European Union would release the last tranche of the €110 billion loan because Greece's prime minister was facing a vote of confidence and the Greek parliament had to vote to pass additional austerity measures. If either of these votes had not passed, it is likely the loan funds would not have been released. Luckily, both votes did pass, and Greece is on schedule to receive the additional funds. It appears that Greece will also be receiving a second loan of approximately €109 billion over the next three years from these same two groups.

Ireland and Portugal have also been embroiled in the debt crisis. Both countries have seen significant spikes in their borrowing costs. Earlier this year, Ireland received an €85 billion package and Portugal received a €78 billion package.

The actions by the IMF and European Union have been largely taken to keep the debt crisis from spreading to other larger countries such as Spain and Italy — which have much larger amounts of debt outstanding than Greece, Ireland and Portugal — and to protect banks in the Eurozone area that hold significant amounts of debt issued by Eurozone countries.

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Overview

Investors tend to overweight their equity portfolios with stocks from their home country market. Ken French says that, while home bias is still the norm, investors have significantly increased their allocation to foreign markets over the last 30 years.

He explains that investors might overweight their home market for economic reasons, perhaps to hedge consumption risk or to offset tax disadvantages they suffer in some foreign markets. Home bias can also be driven by behavioral factors. For example, investors may overweight their home country because of their uncertainty (the unknown unknowns) about foreign markets, or because they are overconfident about picking stocks in their home market.

Ken says the best approach is to start with a global market portfolio, then make adjustments based on personal preference.

The excerpt below highlights home bias because of uncertainty.

Q: Are there any other behavioral reasons that would lead people to overemphasize their home country?

A: I like to explain [one] in terms of Donald Rumsfeld's classic line. He was President George W. Bush's secretary of defense, and what he famously said was, "There's what you know, and there's what you don't know, and there's what you know you don't know, and then critically, there's what you don't know you don't know."

And when it comes to investing, it looks like people feel comfortable about what the risks are in their home country, and then as they leave their home country, they start to be less sure about where are the risks, what might get them.

So [with] Rumsfeld's inside-the-U.S.-for-me, for example, it's "I know what I don't know." But then, when I go outside the U.S., "I don't even know what I don't know."

And that creates what Frank Knight, who was an economist in the first half of the 20th century, [called] the distinction between risk and uncertainty. Well, that uncertainty outside the U.S. may be pushing investors to tilt less of their portfolio outside their home country.

About This Commentary: This Q&A excerpt appeared in a May 31 video on the Fama/French Forum hosted by Dimensional Fund Advisors. To view the video, visit <http://www.dimensionalfundadvisors.com/famafrench>.

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Potential Effects on the Global Economy

The ramifications for the global economy are significant. Europe is a large portion of the world's economy, and a slowdown in Europe would likely be felt elsewhere. However, at this point, fears of this episode turning into a crisis of similar magnitude to the events of 2007–2009 seem unfounded.

The debt associated with the European crisis is more transparent and less complex than the subprime debt that drove the 2007–2009 crisis, and European banks appear to have less exposure to this debt than banks in general had to subprime debt. Only time will tell how severe the crisis will be, and efforts to predict such things are usually futile. However, crises like the European debt crisis remind us of the fact that without risk there would be no reward.

**MAKING PLANS****The Roots of Estate Planning**

Many people assume estate planning documents are strictly financial in nature. In reality, having such documents in place also expresses an individual's personal instructions regarding health care preferences, family care and cherished belongings.

Properly prepared estate planning documents provide value beyond the possible reduction in estate taxes. The following four areas are part of the estate planning process:

Power of attorney

The power of attorney document provides the transfer of decision-making authority to a selected person in the event an individual is unable to make decisions related to his or her assets. This is significant for an individual who becomes incapacitated. The appointed person would administer financial obligations in accordance with the individual's clearly stated goals and objectives.

Health care directives

Health care directives include comprehensive care instructions and the selection of appointed decision makers. These directives represent the personal decisions of an individual regarding acceptable treatments, quality of life, and specific instructions for doctors, family and friends.

Guardian designation

Estate planning documents can include language for naming guardians for minor children in the event of an untimely death of both parents. The decision to select a guardian is complex. The guardian and home environment selected should be appropriate for the minor child but also must be acceptable to both parents.

Memo regarding personal effects

Assets that have significant sentimental value should be transferred in writing either as a specific bequest in a will, trust document or a memo regarding personal effects. Common examples include jewelry, furniture or artwork. By designating transfer, the author of the memo controls division of these assets and potentially prevents conflict among family members.

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