As government spending hits record levels around the globe, some politicians, economists, and pundits are warning that rising indebtedness may drag down economies and financial markets. This issue has raised concern among investors who assume that a government’s fiscal policy is closely linked to the country’s economic growth and market returns.

The graph below shows the projected state of indebtedness around the world.¹ Over half the Organisation for Economic Co-operation and Development (OECD) member countries expect to have debt-to-GDP levels above 70%—and the US, Canada, and the UK project debt levels exceeding 80% of their economic output.

Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions, and rising health care obligations are compounding the fiscal challenges of these countries.

Global investors may be particularly concerned about the economics of government spending in countries around the world. So how does public debt affect economic growth and market returns? The evidence might surprise you. Although rising levels of government debt create headwinds

¹ Source: Organisation for Economic Co-operation and Development (OECD)
for economic growth, a country’s deficit and debt levels do not seem to adversely impact capital market returns.

Let’s explore these issues by addressing a few popular questions about sovereign debt:

Do rising deficits drive up interest rates?

Yes. As borrowing increases, a government must offer higher interest rates on its debt to compete for capital. The public sector consumes savings and investment that may have otherwise fueled private sector growth—a displacement of resources known as the “crowding out effect” in economic theory. Additionally, as debt levels rise, market concerns about higher default and inflation risks put additional upward pressure on interest rates.

Consistent with this theory, an analysis by Dimensional Fund Advisors (DFA) shows that current interest rates reflect expectations of future deficits, but that current government deficits and debt do not predict future interest rates or bond returns. So, long-term interest rates rise when the market expects future deficits to increase. However, today’s interest rates and bond prices already reflect information about current government spending, and markets quickly incorporate new information.

**Bottom Line:** Investors should consider high quality, short-term bonds as a reasonable hedge against rising interest rates and default risks.

Do higher deficits hamper economic growth?

It depends on a country’s debt level. Using World Bank data from 1991 to 2008, DFA compared current deficits to future GDP growth in sixty-seven countries and found an increasing interactive effect among deficits, debt, and economic growth. High-debt countries that run deficits are more likely to experience lower economic growth over the next three years. But numerous forces may affect a country’s economic direction, and deficits explain only a small fraction of the variation in future GDP growth. The combination of high debt and deficits can create headwinds for economic expansion, but slower growth is not guaranteed.

So investors are justified in having some economic concern about higher government spending and borrowing. But the impact on investment returns is less clear. Let’s now consider the potential effect on equity markets.

Does low economic growth result in diminished equity returns?

No. This relationship can be tested by comparing a country’s GDP growth to its equity market performance in subsequent years. DFA conducted this analysis using all the developed countries in the MSCI universe, divided each year into high-growth and low-growth “portfolios” based on growth in real GDP. There was no statistical difference between the annual returns of equity markets in high-growth and low-growth countries. In fact, low-growth countries had slightly higher average returns than high-growth countries.

The graph below illustrates this relationship in terms of a dollar invested in high- versus low-GDP growth portfolios from 1971 to 2008. The low-GDP growth portfolio’s higher annual return would have generated slightly more wealth for the period. The chart details the average annual return and real GDP growth for both groups.

Applying the same methodology to the MSCI emerging market countries shows an even greater return difference, although the data period is much shorter (2001 to 2008). The return of the high-growth country portfolio averaged 19.77% (with 2.5% GDP growth), versus 24.62% for the low-growth portfolio (-4.94% GDP growth).

**Economic Growth Does Not Predict Equity Returns**

*Growth of $1 in the Stock Markets of Developed Countries*

<table>
<thead>
<tr>
<th>Year</th>
<th>High GDP Growth Countries</th>
<th>Low GDP Growth Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>12.90%</td>
<td>13.52%</td>
</tr>
<tr>
<td>1975</td>
<td>9.92%</td>
<td>-4.02%</td>
</tr>
<tr>
<td>1980</td>
<td>12.90%</td>
<td>13.52%</td>
</tr>
<tr>
<td>1985</td>
<td>12.90%</td>
<td>13.52%</td>
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<tr>
<td>1990</td>
<td>12.90%</td>
<td>13.52%</td>
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<td>1995</td>
<td>12.90%</td>
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<td>2000</td>
<td>12.90%</td>
<td>13.52%</td>
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<tr>
<td>2005</td>
<td>12.90%</td>
<td>13.52%</td>
</tr>
<tr>
<td>2010</td>
<td>12.90%</td>
<td>13.52%</td>
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</tbody>
</table>

*Source: MSCI*

Continued on page 3
Other research has confirmed a weak relationship between a country’s economic growth and its stock market returns. Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company’s stock price in its home market may not reflect economic conditions in other countries. Also, the fruits of economic growth do not accrue exclusively to public companies, but also to income earners, nonpublic businesses, and private investments.

Finally, consider that risk, not economic growth, determines a stock’s expected return. Research indicates that this principle also applies to a country’s stock market. Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns.

Consequently, while holding a “growth market” may be a rational investment approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

Bottom Line: Investors should consider a tilt to small cap and value stocks of developed countries as an alternative to stocks of risky emerging countries, regardless of projected GDP growth rates for these countries.

Do fiscal deficits lead to currency depreciation?
No. It is commonly believed that large fiscal deficits and high debt cause a currency to depreciate as the government borrows more from foreign sources, and investors who are concerned about inflation and default risk flee the currency. Although recent developments in the U.S. would seem to support this relationship, there is less convincing long-term evidence that deficits affect currency rates. During the 1970s and 1980s, the dollar strengthened while the government increased deficit spending. This observation is consistent with academic studies concluding that exchange rates appear to move randomly, and there are no models to date that can reliably forecast currency returns.

Bottom Line: Investors should consider owning both U.S. and foreign stocks in order to hedge currency exposure.

Conclusions
Some economists claim that developed market countries are moving into an era of high government deficits and lower market returns. While higher deficits and debt may impact a nation’s interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country’s financial markets, or anticipate short-term currency movements.

Investors should assume that stock and bond prices reflect all that is currently known and expected about government spending and debt, economic growth, risk, and other issues affecting performance.

Bottom Line: Investors should seek customized portfolio strategies that balance asset class, interest rate, currency, and other risks based on their personal objectives and risk tolerance. Combining rational expectations with disciplined adherence to a long-term plan can reduce uncertainty and increase confidence that goals will be met.

1. The Organization for Economic Co-operation and Development (OECD) is an international economic organization of thirty-three countries founded in 1961 to stimulate economic progress and world trade. It defines itself as a forum of countries committed to democracy and the market economy.
2. Today’s interest rates reflect expectations of future deficit levels. The analysis compared five-year US deficit projections (as a percent of GDP) to yield spreads (five-year US Treasuries minus three-month US Treasuries) from 1992 to 2010. The yield spread increased 29 basis points for every one percentage-point increase in projected deficits. Data sources: Baseline projected deficits from the Congressional Budget Office; yields from the Federal Reserve Bank of St. Louis.
6. Another common assumption is that current account deficits and currency appreciation are related. (The current account balance is the difference between a country’s receipts and payments to the world. This account is composed mostly of the balance of trade, with net income and foreign aid playing a smaller role.) Academic research yields equivocal results on whether this relationship holds.
Equius Partners is blessed with wonderful corporate clients who have hired us to manage their 401(k) plans. In each case, management has spent the necessary time to understand their fiduciary responsibilities to employees in the plans; the significant advantages indexing and asset class investing offer over active management; and the positive impact sound, consistent investment advice has on participants’ investment behavior.

Equius is on the leading edge of a growing trend in the 401(k) market that is bending the cost/benefit curve back to plan participants and away from old-school advisors. But we and like-minded “new age” advisors are a very small minority in this arena.

Too bad, because as corporations and municipalities struggle with underfunded pension plans, more and more plan participants and their assets will be shifted to 401(k)-type plans. Old-school Wall Street—with its high costs, false promises of guru-generated “superior” returns, and overall bad advice—dominates this market today and will for many years to come. As a result, millions of investors in 401(k) plans will end up with inadequate retirement balances at a time when the Social Security system faces its own massive challenges.

We have long believed that the only thing that will force real change in the 401(k) market is a continuous string of high-profile lawsuits that cost brokerage firms, insurance companies, mutual fund complexes, and corporate plan sponsors billions of dollars in financial liability. Regulation (at least of the type normally crafted by politicians) will not alter this destructive curve in any meaningful way. How realistic is it to assume that these lawsuits will materialize?

Not very. The American Law Institute (ALI) published a well-researched and timely restatement of “The Prudent Investor Rule” in 1992. The lawyers, editors, and researchers were very clear and forceful in their indictment of active management by calling it what it most certainly is: uncompensated risk.

The Prudent Investor Rule was obviously (and appropriately) looking at issues like risk, expected return, and cost from the investor’s perspective. Sadly, for millions of retirees, the revised Rule has been roundly ignored by the vast majority of plan sponsors and investment advisors ever since. And old-school adherents of active management continue to be richly compensated, with very little risk to their businesses, as they feed like pigs at the 401(k) retirement plan trough.

So what to do? I propose that Congress draft regulation similar to what they imposed on the tobacco industry: Require every 401(k) plan that includes actively managed mutual funds or portfolios to carry warning labels.

It might not change behavior right away, but it will almost certainly excite the plaintiff’s bar and put Wall Street in its crosshairs. Here are just a few of my suggestions:

1. **WARNING!** Your plan investments are based upon thoroughly discredited Wall Street myths and misrepresentations.
2. **WARNING!** It’s very likely that the executives in charge of hiring the investment advisor for this plan have not read (or have chosen to ignore) the American Law Institute’s 1992 restatement of “The Prudent Investor Rule.”
3. **WARNING!** The investment principles on which the plan investments were selected have collectively failed to outperform lower-cost and more diversified index funds for decades.
4. **WARNING!** The so-called “superior” investments for your 401(k) plan were selected using $700 software and fifteen minutes of “research” by “professionals” who are secretly paid by the mutual funds they recommend.
5. **WARNING!** Your plan investments are based upon thoroughly discredited Wall Street myths and misrepresentations.
6. **WARNING!** This 401(k) plan has unnecessarily high fees and costs that shift a significant amount of your future wealth to people who don’t deserve it.
7. **WARNING!** The investment advisory firm for this plan has not provided a track record of prior 401(k) recommendations. But, hey, their current selections all have ★★★★★★s! (Please see prior warning.)
8. **WARNING!** The “self-directed brokerage” option of this 401(k) plan allows you to transfer more of your retirement wealth at a faster pace to the brokerage firm of your choice. Enjoy.