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What Exactly *Is* This Debt Ceiling?

With the NBA and NHL finals underway, fans in Dallas, Miami, Boston, and Vancouver are "raising the roof." In Washington, D.C., our political leaders are trying to raise the ceiling, the debt ceiling, that is.

In simple terms, that ceiling is the total amount of debt that Congress has authorized the Treasury to incur backed by the full faith and credit of the republic. And that authorization currently is limited to roughly $14.3 trillion. That may seem like plenty of headroom, but we are bumping up against the ceiling, at least the way Congress is legally bound to define it.

The biggest chunk of the debt is in the form of outstanding Treasury securities. That's the "debt held by the public" which at the end of fiscal 2010 (last September 30th) stood at just over $9 trillion. Eight months into the *current* fiscal year the Treasury's Debt Position and Activity Report shows $9.72 trillion in debt held by the public. By the way, that "public" is vast; about half of that outstanding debt is held by *non*-U.S. investors: foreign nations, institutions, and individuals.

So, if total debt held by the public is just approaching $10 trillion, why are we bumping up against a $14.3 trillion ceiling? That takes us into the world of the Social Security and Medicare Trust Funds. Those "funds" are a historical accounting of the excess of payroll tax collections over Social Security and Medicare expenditures. Over the past 25 years that excess has been considerable, and by law it must be credited to the respective Trust Funds.

Of course the actual cash has been spent along the way, leaving the Trust Funds with special, non-traded Treasury securities on which the Funds are credited interest as time marches along. These accumulated "balances" provide a useful record as well as the legal framework within which Social Security and Medicare benefits will continue to flow at whatever point payroll taxes fall short of those outlays.

Tracking the Debt

Outstanding U.S. Treasury Obligations

As of Fiscal Year-end	Held by Public (in $ billions)	As a % of U. S. GDP
1980	$ 711.9	26.1 %
1984	1,307.0	34.0
1988	2,051.6	41.0
1992	2,999.7	48.1
1996	3,734.1	48.4
2000	3,409.8	34.7
2004	4,295.5	36.8
2008	5,803.1	40.3
2010	9,017.8	62.1
2011 est.	10,400.0	69.2

Source: *Congressional Budget Office*

Those Trust Funds represent the largest portion of what Treasury's Debt Position and Activity Report lists as Intra-governmental Holdings, totaling $4.62 trillion as of May 31st. It may seem counterintuitive, but the law requires those "balances" to be counted as part of the total debt capped by the ceiling.

Whether this truly constitutes a debt or just a formal recognition of a compact across generations makes for an interesting discussion. But as the accompanying table shows, the plain old debt held by the public is growing plenty fast enough to lend a sense of urgency to the ceiling debate and highlight our political and philosophical divisions. ■

Japan in the Wake of Catastrophe

Scenes of devastation from the earthquake and tsunami that hit Japan in March defied description. The resulting meltdown at the Fukushima nuclear plant has prompted a global rethinking of that energy source.

All this comes after two decades of serial economic disappointments and a dismal stock market. Battling the forces of economic contraction and deflation, Japan's government has run up net cumulative debt of roughly 130% of its gross domestic product (GDP). Annual deficits are projected to run about 7% of GDP.

The demographic obstacles to robust growth are notable. The UN projects Japan's working-age population will decline from 81.5 million to just 51.8 million over the next 40 years. So, is there any good news?

Japan's economy had shown relative improvement starting around 2003. But it has been overshadowed by a global financial crisis and this latest stunning natural disaster. According to a recent special report in the *Bank Credit Analyst*, Japan's long run of wage and asset deflation should be abating with positive implications for growth.

Japan's mountain of government debt looks perilous, but there appears to be room to maneuver. Government revenue as a percent of GDP is one of the lowest among OECD countries, and recent polls indicate public receptivity to higher taxes to support infrastructure spending.

Despite the demographic challenge noted above, the public pension system is believed to be fully funded for the balance of the century. A 2004 reform of the system included a phasing in of higher contribution

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A Few Tips on TIPS

Treasury Inflation Protected Securities, or TIPS, were still under discussion in the halls of the U.S. Treasury Department when they were first covered in these pages 15 years ago. The following year they started to take their place as a portfolio tool for a wide range of individual and institutional investors seeking high-quality credit instruments with some protection against any sustained resurgence of inflation.

To review, TIPS are Treasury bonds with a distinguishing feature: bond principal is adjusted annually based on the Consumer Price Index (CPI). The fixed coupon rate is then applied to that new principal base. So both principal and interest should respond to inflation over time.

The 1990s turned out to be disinflationary, but memories of 1970s-style inflation were still fresh. When TIPS debuted in 1997 we noted that "bond prices shift as much on inflation *expectations* as on actual changes in the CPI, and the new securities could just as easily *underperform*" conventional Treasury securities."

The ensuing 14 years have in fact been pretty good to holders of long-dated, conventional Treasurys due to the huge secular decline in interest rates to historic lows. Many market participants believe the trend must turn at some point with higher inflation fostered by highly accommodative monetary policy.

For conservative portfolios, TIPS may be part of the answer. But unlike 14 years ago, they now have a real trading history to examine. The correlation between TIPS and conventional Treasurys of comparable maturity has been positive and fairly high – about 0.60. A perfect correlation would measure at 1.00. On the other hand, the correlation between TIPS and the CPI has been quite weak – about 0.10.

It's also important to remember that TIPS are still longer-duration Treasury bonds that retain a measure of interest-rate risk. The CPI-based adjustment occurs just once a year, and the boost it provides to subsequent coupon interest could be considerably smaller than the general rise in interest rates in an inflation-spooked bond market.

Investors looking to TIPS for inflation protection will want to keep a long-term perspective and recognize that the securities can experience price volatility. Last year, 10-year TIPS prices rose from 100 to nearly 110 but also fell at one point to just above 97. TIPS adjust to inflation in a prescribed manner over time. Markets can move much more quickly and less predictably. ■

Quest for Income: Navigating High Yield

A quick check of this issue's Investment Performance Review reveals that high yield corporate debt has been a top performing asset category for the past three- and five-year periods. With investors craving income, the fat pick-up in yield relative to U.S. Treasury or high-grade municipal debt is tempting indeed.

High yield bonds appear capable of equity-like upside, but it must be noted that they can deliver equity-like downside as well. According to Morningstar, high yield mutual funds tumbled more than 26% in 2008 before storming back over 47% in 2009. Of course 2008 featured a credit crisis that froze out all but the bluest chip companies.

In any environment, credit analysis is the name of the game for high-yield fund managers. Equity holders get most of the upside if a company does well, so a bond investor focuses on the risks of significant credit impairment or even default. The accompanying table shows a big jump in the historical odds of default for bonds rated below investment-grade (Baa and above).

Bonds Rated*	Avg. Cumulative 5-Year Default Rates*
Aaa	0.08 %
Aa	0.15 %
A	0.41 %
Baa	1.60 %
Ba	7.86 %
B	20.66 %
Caa - C	39.32 %

* Moody's Investor Service 2006 Study

Bond analysts often start with a

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Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	--- Annualized thru June 3, 2011 ---			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Core)	18.6 %	– 0.4 %	1.9 %	2.0 %
Mid-cap Stocks (Core)	23.9	2.6	3.9	5.6
Small-cap Stocks (Core) †	22.9	4.1	3.0	7.0
Foreign Stocks (multi-cap) †	26.5	– 3.0	1.8	6.3
Emerging Market Stocks †	25.4	– 0.8	8.8	15.0
Natural Resources	37.6	– 6.1	4.7	9.1
Real Estate related	26.5	1.5	2.2	10.5
Flexible Portfolio	16.2	2.7	3.9	4.6
General Bond	7.9	4.9	5.4	7.1
Int'l Fixed Income †	15.9	7.0	6.8	7.3
High-Yield Taxable Bond †	16.8	8.8	7.0	7.0
General Municipal Debt	2.4	3.5	3.2	3.9

* Source: Lipper, as reported in the *Wall Street Journal*, June 4, 2011. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

For Variable Annuities, a Decade of Evolving Risk Controls

Ten years ago the *Quarterly* took a look at the "new, new thing" in variable annuities, guaranteed income benefits. The ensuing decade was bracketed by two bruising bear markets highlighting the downside potential in even the best-laid portfolio plans. A rising tide of retirees and near retirees seeking some kind of backstop against such market risks has made guaranteed income benefits a prime driver of variable annuity (VA) sales. But how do those guarantees work, and what are the trade-offs?

Today's most popular VA contracts wrap the insurer's guarantee around some level of future income for the balance of one's life. Most variable annuity investors do not draw immediate income, so a contract may guarantee an annual rate of increase (perhaps 5% or 6%) in the principal base on which the guaranteed level of income would be calculated. It is critical to understand that that rising income base is *not* the same as principal that can be freely drawn from the contract at any time.

It's also important to consider the degree of flexibility in triggering the income guarantee. Some contracts allow an investor to draw that guaranteed income while continuing to enjoy potential gains from the underlying investments. Others may require that the contract be annuitized to take advantage of the income guarantee. Annuitizing generally means irrevocably converting a lump-sum into a guaranteed income stream, either for life or some specified number of years.

Some income guarantees come with restrictions on the range of investments one can hold within the variable annuity. The insurer takes on the risk that if the underlying investments perform poorly, it will have to deliver a level of income that would not be supported by the diminished investment accounts. Companies are understandably skittish about backstopping the most aggressive investment posture a contract holder might take. VA investors should carefully consider these and other restrictions that could void the guarantee if violated.

Like any form of insurance, income guarantees carry a cost. Depending on the terms of the guarantee, the added contract charge may run anywhere from 0.30% to 1.7% of the contract value. If the markets and one's investment choices perform reasonably well, the value may simply lie in having helped one sustain a long-term strategy through periods of downside volatility.

Finally, it should be noted that a variable annuity is a contract that should be reviewed periodically to see if its terms still match your objectives, and in light of intervening investment performance. As time goes by, things change. ■

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... Navigating High Yield

company's balance sheet to assess its debt relative to certain metrics. Turning to the income statement, earnings before interest, taxes, depreciation and amortization (EBITDA) indicate the capacity of current operations to cover debt service.

Another consideration is the schedule of maturities of a company's outstanding debt. Many companies are not structured to be able to pay off debt at maturity; they count on being able to refinance. But events beyond a company's control can conspire to make that difficult. At the height of the crisis in 2008 even blue-chip companies had difficulty rolling over their short-term commercial paper.

Across a diversified portfolio of high-yield bonds some defaults are apt to occur. Analysts must assess where a debt issue would stand in a bankruptcy and what assets of the company might be available to pay back some, if not all, of the principal. To most of us, this kind of analysis may not sound like much fun. Fortunately there are professionals who do it all day long. ■

Sources for Info on Long-Term Care

Long-term care is not something most folks shop for every day. In fact it's often a once-in-a-lifetime event, with adult children trying to arrange care for parents who live in an entirely different part of the country. How does one gauge value and competitive pricing for an outlay that can quickly run into tens of thousands of dollars?

The surging demand for such information is being met by some key players in the long-term care arena. Two leading underwriters of long-term care insurance maintain online resources to help families bolster their knowledge. Genworth Financial has a dedicated site, *www.Genworth.com/costofcare*, that looks at costs for a range of services across the country. MetLife provides its "2010 Market Survey of Long-Term Care Costs" at *www.MatureMarketInstitute.com*.

United Hospital Fund maintains its "Next Step in Care" website (*www.nextstepincare.org*) with a wealth of information for family caregivers. The federal government is a significant player as well. Although Medicare generally does not cover nursing home stays, *www.Medicare.gov* does carry the publication "Medicare and Home Health Care," describing the home-health-care expenses that *are* covered by Medicare.

Genworth Financial's caregiver support unit recently released its annual survey of long-term care costs. The national median monthly rate for a one-bedroom assisted-living unit came in at $3,261, up 2.4% from 2010's survey. Extra services can add costs quickly, but sometimes there's room to negotiate. And when it comes to negotiating, more knowledge is better. ■

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Japan in the Wake...

rates from workers. Health care expenses will rise with an aging population, but from a low current base of just 8% of GDP.

There is a qualitative difference between Japan's government debt and that of other developed nations. Nearly all of Japan's is held by its own citizens and institutions, a reflection of their high propensity to save. To the rest of the world Japan is a creditor nation with net foreign assets exceeding 60% of GDP – assets that can be drawn down over time to meet domestic needs.

For investors the question moves from macro-economics to the prospects for Japanese stocks. Since 2000 Japan's listed companies have shown better per-share earnings growth than their European and U.S. counterparts. Productivity gains have been noteworthy as well. And some 30% of sales now come from overseas with exports to China up more than tenfold over the past 10 years.

Yet Japanese stock valuations are at levels associated with past market troughs. For the first time in three decades they're trading at lower multiples of projected earnings than comparable global competitors. Japan's challenges are considerable, but the record of global competitiveness and resilience in the face of adversity merits some consideration. ■

Listening Through All That Noise

Efficient market theory holds that stock prices represent the balance point of all known information bearing on those securities. It's a neat theory, but on any given day anomalies abound. Consider, for example, the recently reported connection between movements in the price of Berkshire Hathaway stock and the publicity accorded movie star Anne Hathaway.

For the record there's no real connection between the two. Berkshire Hathaway is the holding company for a host of operating enterprises plus a huge portfolio of securities, all overseen by Warren Buffett, the "Sage of Omaha." Anne Hathaway has graced a series of seemingly successful romantic comedies.

But in this era of rapid-fire, computer-driven trading, some programs simply scour the media for apparent trends and the sheer frequency of a company's name being mentioned. Market watchers have noticed that when Ms. Hathaway is in the news Berkshire Hathaway stock seems to get a boost. Examples include gains for Berkshire coinciding with the openings of several of Ms. Hathaway's movies as well as her co-hosting of this year's Oscars.

The Hathaway effect is perhaps a rather silly illustration of a useful point. In the short run, markets can be quite *inefficient* – even irrational. Estimates are that high-frequency trading constitutes as much as 70% of daily volume on U.S. stock exchanges. Being able to listen through most of that noise is just one of the challenges in maintaining a focus on basic investing principles and a disciplined strategy. ■

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