ADDING VALUE

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SOVEREIGN DEBT

In 1790, at Alexander Hamilton's direction, the new nation took out its first loan of $20,000. Today, the federal government increases its debt about $20,000 every 3/10 second. Ordinarily, this macroeconomic issue would not directly be of concern. Macroeconomic issues, while informative, do not determine our ability to analyze valuations and our primary investment focus has always been to find good companies at cheap prices. We make an exception with this newsletter as we try to make sense of the enormously complex national debt situation. We present this analysis in the spirit of objectivity, although we realize that someone will be offended by each of the ideas. Our deficit problems today have no easy answers or solutions.

There are worries facing the entire global economy. In the U.S., two problems are upon us at once: short-term stimulus that is unaffordable and runaway entitlements that must be halted. As a result of the constant bombardment of data, we thought it would be worthwhile to examine the actual balance sheet and income statement of the U.S. to understand for ourselves the issues. So the purpose of this newsletter is to:

- Outline the current state of federal finances
- Consider some of the proposed solutions
- Evaluate the implications for investment strategy
- Highlight some of the comments of the most vocal of the mutual fund managers on this issue in your portfolio

Current state of the federal finances

Despite the enormous complexity of the individual line items in the federal budget, the big picture is easy to understand. ***On an annual basis, spending has been exceeding revenues, and this has been generating a fast-growing deficit which annually adds to our national debt.*** The numbers are large both on an absolute basis (for instance, if the President's budget is enacted and no changes are made, the "debt held by the public," known as net debt hereafter, could climb to $20.8 trillion by the end of fiscal year 2021 compared to an expected $10.4 trillion at the end of this year) and on a relative basis as a percent of GDP (for instance, over the next decade, the net debt could climb to almost 90% of the GDP, from 70% this year). Just like debt held by individual taxpayers, over-leverage decreases flexibility and increases risks.

J.P. Morgan makes two additional points about the nature of this problem which are instructive. First, "over the past 50 years, federal revenues have averaged 18% of GDP, but in the current year, they are set to amount to just 14.8%. During the same period, federal spending has averaged 20.5% of GDP, but in the current fiscal year, it should amount to 24.3%. This strongly suggests that any honest approach to balancing the budget requires both revenue increases and spending cuts."

The second point to make is that the budget cannot be balanced purely by hammering discretionary spending and/or increasing revenues.

ADDING VALUE is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

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This statement can be shown most simplistically in the following schedules:

LACK OF DISCRETION

2011			
Federal Spending by Category	**Amount (bil)**	**% of Total Expenses**	**40 Year Average**
Medicare + Medicaid	$841	23%	42%
Social Security	727	20	
Defense	733	20	24
Non-defense-discretionary	636	17	23
Net Interest	214	6	11
Other	504	14	0
	$3,655	**100%**	**100%**

Source: CBO, JP Morgan

Financing of 2011 Spending

	Amount (bil)	**% of Total**
Revenue	$2,228	61%
Borrowing	1,427	39
Sources of Financing	**$3,655**	**100%**

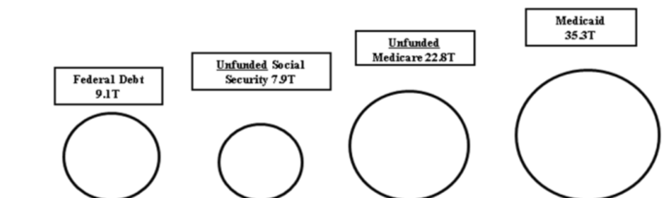
Source: CBO, JP Morgan

The reality is that the USA is currently borrowing almost 40% of total government spending. If we eliminated all non-defense discretionary spending, it would still amount to only half of the current deficit. (i.e., $636 billion would be eliminated from total borrowing of $1,427 billion). Alternatively, if we eliminated all spending on Social Security and defense which total $1,460 billion in 2011, it would just cover the deficit. Put another way: the largest and fastest growing line item in the budget is entitlement spending. The table allows us plenty of opportunity to pick and choose what can be eliminated, but it is obvious that the 800 lb. elephant, in one way or another, involves the reduction of entitlement spending.

Furthermore, there is still more bad news. Two points articulated by Bill Gross, CEO of PIMCO Funds and the largest bond manager in the world, is that all of these budget calculations first, have very low numbers for the net interest on the public debt, and second, neglect to consider the UNFUNDED liabilities of the U.S. government. To address the first point from the schedule above, net interest for 2011 is only $214 billion, or 6% of total expenses. This number has got to go up whenever the U.S. government starts to pay any kind of interest to its bondholders. Higher debt levels mean more resources devoted to compounding interest payments on the debt, which increasingly go abroad rather than stay in this country. Thus, we have even less for education and infrastructure, etc… Bob Rodriguez, never one to mince words, states: "The Fed policy (of low interest rates) is an abject, unmitigated attack on savers—and a horrendous attack on people who are in or near retirement." Currently net interest expense equals 1.4% of GDP, but it is projected to increase to 3.9% by 2021. Most of this increase is due to the higher interest rates that are projected in the future. Therefore, cutting federal spending back to 20.5% of GDP (the long term average) is not enough given the expected increase in interest rates; instead it would have to be cut to 16.6% of GDP, a truly daunting prospect from the current spending rate of 24.3%.

Second, it may come as a surprise to some that the net debt at almost $10 trillion in 2011 does NOT include Social Security, Medicare, or Medicaid. These are UNFUNDED Balance Sheet Liabilities. They are shown in the box below.

USA Balance Sheet Liabilities



Source: A Basic Summary of America's Financial Statements, USA, Inc. Mary Meeker

These unfunded liabilities total $66 trillion. They are not an estimate of future spending. They are the discounted net present value of current spending *should it continue at the projected demographic rate.* It should become immediately apparent when viewed in this way that the tiny little ball representing the $10 trillion Federal debt expected by 2011 year end in the chart is nothing compared to the unfunded Medicaid and Medicare liabilities. It should further give one pause when a Congressman or Senator states that Medicaid and Medicare is appropriated annually and therefore requires no discounted reserve that they are: 1. spending too much time avoiding personal taxes, or 2. their sexual exploits are too demanding, or 3. there are too many golf outings with their friends at Fannie Mae or Freddie Mac. There is one more tweak of bad news. In the "Lack of Discretion" Chart, we indicated that the net interest expense was projected to be $214 billion in 2011, based in part on the Fed keeping rates at very low levels. Just suppose we allocated an interest cost to the unfunded liabilities and were required to pay a market rate of in-

terest to the Chinese on this debt—well that is an Excedrin headache. Or as Bill Gross (referenced earlier) states: "we are out-Greeking the Greeks, dear reader."

Dealing with the Debt Problem

There are basically three fundamental proposals on the table to solve this problem:

- The Bi-Partisan Deficit Commission proposal (The National Commission on Fiscal Responsibility and Reform of December 2010).
- The Ryan Proposal (The House Budget Resolution of April 5, 2011).
- The President's Proposal (Remarks by the President on April 13, 2011).

The first proposal treated nothing as "off the table," was supported by only 11 of the 18 members and concentrated on holding discretionary spending to pre-2008 levels, increasing the gasoline tax, reforming taxes on both corporations and individuals, phasing-in an older age of eligibility for Social Security beneficiaries, reforming Medicare and Medicaid, among other issues.

Ryan's proposal which cuts $4.4 trillion over 10 years attempts to do most of it from the spending side, most notably through controls on Medicaid and Medicare. He leaves the growth in defense spending and Social Security largely untouched. His revenue proposal is mostly broad tax reform, including reductions in mortgage interest deductions.

The President's proposal cuts $4 trillion from the cumulative deficits over the next 12 years with an emphasis on tax increases, lower interest costs and spending cuts in defense, non-defense discretionary programs and medical programs. Obama's emphasis continues to be biased toward tax increases and his proposal already assumed the end of the Bush era tax cuts as the starting point.

Neither Ryan nor Obama propose any changes to Social Security. Neither of these proposals (which cut about $4 trillion of a projected $10 trillion increase) eliminate the projected growth in net debt over the next 10 years. Not even close at only 40%.

It was helpful to us to put all of this debt debate in the proper perspective and magnitude. Overall, the good news is that we are now at least paying attention to the problems and trying to solve them. The bad news is that there is still a "National Economic Predicament." Recipients of government handouts will always grumble at the termination of policies that offer them outsized benefits. There will never be a good time to end housing support programs, reverse quantitative easing policies, end fiscal stimulus, or reduce budget deficits. There will never be a good time to cut entitlement programs or to solve Medicare or Social Security underfunding. None of the compelling human interest stories which tug at our heartstrings and make us question our humanity and kindness will make this epic problem go away.

As Seth Klarman states in his 2010 Baupost Group Letter: "The financial collapse of 2008 highlighted our national predicament. The sudden decline in consumer activity that followed the plunges in the housing and stock markets represented a reasonable-indeed a desirable-response to over indebtedness. Yet the Federal Government saw this well-advised retrenchment as cataclysmic, because the national economy had grown dependent on our living beyond our means. The imagination of our financial leaders remains so shallow that their response to a crisis caused by over-leverage and excess has been to recreate, as nearly as possible, the conditions that fomented it, as if the events of 2008 were a rogue wave of financial woe that could never recur. It is only in Fantasyland that the solution to vastly excessive debt is more debt and the answer to overconsumption is less saving and more spending."

What should be done?

It is difficult in a highly complex, global environment to make choices with limited resources. Many other countries are also searching to find answers to these problems. It seems evident to us that:

1. The Deficit Commission is completely correct in saying that all issues must be on the table. It does not bode well that only 60% of the committee supported the findings. Thinking outside the box and considering higher gasoline taxes, lower corporate taxes, and less complicated personal taxes may be a start.
2. Federal spending on Medicare and Medicaid will need to be controlled and disciplined. It probably was not helpful that the federal government added a Medicare drug benefit under the Bush Administration and agreed to a huge increase in Medicaid participants under the Obama health care reform. Behaviorally, it is so much easier not to give in the first place, then to remove a benefit once granted. Unfortunately, the size and projected growth of this juggernaut of entitlement spending means that it must be addressed and soon.
3. Social Security is a much less open-ended expenditure of the Federal government than Medicare and Medicaid. We generally know for every person in the U.S., the amount and timing of the expenditure. From actuarial tables, we have good aggregate data

on total payouts. What has changed from the initial design of the program is the life expectancy. We will probably have to require that people defer collections longer, work longer, or cap the benefit to some percentage of what was paid in by the participants.

4. With regard to defense spending, it is possible for some reductions now that Bin Laden has been killed. However, defense spending in 2011 as a percent of total spending is projected to be less than the long term average. Our guess is that any further decrease will be more than offset by the increase in net interest expense from higher interest rates.

No one can be happy with this mess. Seth Klarman states: "By bailing out the economy rather than allowing the pain of the economic and market collapse to be felt, the government has endowed our generation with a "really-bad-couple-of-weeks-mentality": no lasting lessons learned; the government endlessly intervenes in the economy, and, ironically, the first thing to rebound from the 2008 collapse isn't jobs or economic activity but speculation." Bob Rodriguez, of the FPA Funds states: "Many of the questionable practices that were being employed are back in the game. If we continue to grow our debt at a rate of more than double our GDP growth, we will have problems similar to Greece… We need significant fundamental reductions in expenditures at the Federal level this year, because they are not going to happen in 2012, which is an election year. If not, by 2013, we'll be sitting on more than $17 trillion in debt."

Investment Implications

We found the research for this newsletter to be productive to our understanding of the fiscal issues facing the U.S. News media coverage has become so opinionated that it is hard to understand the realities from the emotional pleadings. While of our investment decisions are driven mainly by valuation levels, the magnitude of the debt problem compelled us to review the macroeconomic picture. As such, some of the principles that we are following in these complicated times include:

- Anticipate languid economic growth in conjunction with inflation (look for real return solutions).
- Do not lend money to fiscally irresponsible borrowers (avoid long-term U.S. Treasury bonds).
- Maintain a sustained higher level of liquidity because of the uncertainty of outcomes.
- Do not follow herd mentality and index-like strategies (look for cheap hedge funds).
- Be patient for the best opportunities (buy stocks with substantial margin of safety).
- Review retirement glide path income strategies.
- Expect higher taxes on upper-income individuals including higher taxes on dividends and capital gains.
- Select companies that have diversified geographic sources of revenue.

No doubt heated discussions will continue to rage on these topics. The federal budget will be used as a punching bag in political commercials throughout the 2012 election season. However, it is vital that politicians and the people who elect them consider the ramification of our present financial policy path with clear eyes.

Sincerely,

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