

THE DOWNGRADE

Peter Mallouk, J.D., MBA, CFP
Chief Investment Officer
www.thinkingbeyond.com

After the market closed on Friday, August 5th, Standard and Poor's announced the downgrade of U.S. debt from AAA to AA+. The world collectively gasped.

First, let's start with what, exactly, Standard and Poor's does and why anyone should care, then discuss the implications to the markets and to you as an investor

Investors often loan money to companies and governments. There are lots of companies and countries out there and lots of information about them. Most investors do not have the time to research every little thing about a company or country before loaning them money. Instead, investors look to a ratings agency to tell them if the company or country is strong or not. Three ratings agencies dominate this space: Standard and Poor's, Moody's, and Fitch. These agencies get paid by investors and companies to rate corporations and governments.

Here is a very informal and abbreviated guide of what these ratings mean:

AAA - Best quality borrowers; Loan money to these folks, and you are close to guaranteed that you will get it back

AA - Quality borrowers with a very small chance of having a problem

A - Good, but keep your eye on these guys in a rough economy

BBB - Doing ok right now, but be careful; still considered "investment grade" bonds, as are all the bonds above this level

BB - More at the mercy of the economy than BBB; considered "junk" bonds, as are all the bonds rated below this level

B - Roller coaster

CCC - Very vulnerable; now you are taking big risk

CC - Very, very vulnerable; now you are at Vegas level speculation

C - You are crazy to loan money to these guys; ask for tons of interest because you probably won't get paid back

D - Already defaulted and/or bankrupt

Investors use these ratings to determine if they are willing to take the risk to loan to a certain

Continued...

THE DOWNGRADE

Continued...

corporation or government and if so, how much interest they should require. For example, Microsoft is AAA rated by all three agencies. No one seems seriously concerned that Microsoft will go bankrupt and not pay back its loans. Because of this, they pay you a fairly low interest rate if you loan them money. Right now, Microsoft is paying 3% on a ten year bond (loan). Another company, Sprint is rated BBB. Because of that, investors are getting 9.25% on a ten year bond. Looking at governments, the U.S., up until now, was rated AAA by all the agencies. If you loan money to the U.S. government for 10 years, you will get 3% per year. Greece, on the other hand, is rated BB and if you loan it money for 10 years, you will get 17% per year. Of course, they may eventually default and not pay you.

This is the reason companies and countries care so much about their rating. If a rating goes down, the cost of borrowing to the company or country goes up. This accelerates a downward spiral. For example, if a company is having a bad period and sees its rating go from AA to BBB, the cost of borrowing money could go from 5% to 8%. The extra interest payments could cause the company to get in an even deeper hole. Because the company is then in even worse financial shape, it gets downgraded again, and the process goes on until the company goes bankrupt. The same thing can happen to countries, and is playing out now with Greece and several other European nations.

“In the real world, everyone knows that if the U.S. defaults, everything ends.”

Now, while these rating agencies are certainly powerful, they are currently lacking in the credibility department. It turns out that during the 2008 crisis, they were giving AAA ratings to funds made up of high risk mortgage backed securities. Even more damaging is the fact that Lehman Brothers, Bear Stearns, and dozens of other companies all had AAA ratings within weeks of their demise. So let's be clear here, these folks are not the gold standard for credibility and the market knows it.

Nonetheless, these agencies are a good indicator of a company or country's strength most of the time. The conflicts of interest that resulted in many of the high, unwarranted ratings appear to have been addressed with new regulations.

So, how will this impact the U.S.? Typically, when a company or country gets downgraded, investors demand a higher interest rate from them. All things being equal, investors should charge Canada, Germany, the United Kingdom and France, all AAA rated countries, less to loan them money than to the U.S.

This is likely not going to happen.

Why do we believe that? Because in the real world, everyone knows that if the U.S. defaults, everything ends. Canada cannot function. States cannot function. Microsoft cannot function. The downgrade of the U.S. does not make logical sense, because even a weak America is stronger than everything else. No one believes their money is safer lent to France than to the U.S., not even the French. This is not opinion. The market rates reflect where investors feel the safest. The U.S. is currently paying the lowest interest in the world because investors would rather get less money from the U.S. than a higher payment from China, Canada, France or any other country because investors

THE DOWNGRADE

Continued...

know the safest investment in the world is a loan to the U.S. Many analysts predict that the U.S. may see interest rates go up this week as investors look to loan money to other countries. We do not expect that to happen.

There are also questions around the other implications of the downgrade. First, how can the U.S. be AA+ and an agency backed by the U.S., like Fannie Mae, be rated AAA, as is the case now? This obviously does not make sense, so we expect to see all kinds of entities get downgraded in the coming weeks.

Many charities, businesses, institutions and high net worth clients require that the bond portion of their portfolio only be invested in AAA companies and countries. We do not expect any sell offs due to this requirement since the other two ratings agencies, Moody's and Fitch, have reaffirmed their AAA rating. However, if one of those flips, look out. Both have made clear they have no plans to make a change in the foreseeable future.

So what will happen?

"This may be the first time in history a country gets downgraded and investors then actually want to loan it more money than they did before."

Frankly, we expect that this will completely freak out a good portion of investors, particularly retail investors. Ironically, as the downgrade on U.S. bonds will cause investors to lose confidence in the economy, they are likely to sell stocks, which is the gut reaction of an investor in full-on-fear mode, and buy U.S. bonds. Yes, that's right. Our expectation is that because U.S. bonds have been downgraded, people will sell off riskier assets and put their money in what they perceive to be the safest investment in the world, U.S. bonds. This may be the first time in history a company or country gets downgraded and investors then actually want to loan it more money than they did before. We are in such

unchartered territory that it is not possible to predict exactly what will happen when the markets open, but a several percentage point or so sell off in stocks accompanied by a rally in bonds may be the most logical outcome.

After a few days pass though, we will be left with the same set of issues. Namely, a Congress and President that cannot seem to come to grips with the reality that the budget needs to be balanced (no letters please, let the record show we are dissatisfied with all parties involved). Until this issue is truly resolved, the market's volatility will reflect its uncertainty. It is times like these that enable the disciplined investor to position their portfolio to come out ahead of the pack, as all our clients did in the last three market crises. You can expect similar trades in accordance with our investment strategy now as well, where appropriate. Our long-term clients are familiar with our strategy, which, in a nutshell, is to stay out of the way when markets go up and take decisive, systematic action when markets go down.

While in the short run it may hurt, in the long run (and that is all we care about) *we see the Standard*

THE DOWNGRADE

Continued...

and Poor's downgrade as a good thing. Prior to the downgrade, both sides felt they had actually accomplished something with the previous debt talks. This may be the wake-up call they need to get things figured out, lest the general public demand a new regime in November. As an investor, you ultimately want to be confident that the government is around to pay you back many years from now, you want to be sure the dollars you collect from companies are actually worth something, and you would like your social security check to clear. For these things to happen, the deficit needs to cease to expand at its current rate. Anything that scares the public enough to keep pressure on Congress and the President to do so is a good thing.

And let's not forget that it is not just about being an investor. *As Americans*, we demand the best and expect the best, not just for ourselves, but for future generations. A rating anything less than AAA implies we are not the best, and that is simply not acceptable. Any action to remedy that is positive. Ultimately, that is what will happen, if only because there is no other acceptable alternative. As Winston Churchill said, "*The Americans will always do the right thing... after they've exhausted all the alternatives.*"

A special thank you to Molly Rothove for her assistance with this letter and to one of our clients, Michael C. for the Churchill quote, who must have known we would use it.

CREATIVE PLANNING PRIVATE WEALTH MANAGEMENT

- *Barron's* "Top 100 Independent Financial Advisors in America."
- *Worth's* "Top 100 Wealth Advisors in America."
- *Boomer Market Advisor Magazine* - "#1 Advisor in America for Baby Boomers."
- *Wealth Manager's* "Top Wealth Managers in America."
- *Medical Economics'* "Top 150 Financial Advisors for Physicians."
- *InvestmentNews'* "The Top 50 RIAs: The Fast Movers."
- *Forbes'* "Top 50 Advisors: Growth Surge."

Please visit our website at
www.thinkingbeyond.com.

Thank you for the introductions to your friends and colleagues, and for your continued confidence.

Our clients are always welcome to forward our articles to family, friends and colleagues.

However, it has come to our attention that some of our articles have been plagiarized. Please note: the articles are the property of Creative Planning, Inc. Reproduction in whole or in part is prohibited.