

Lessons From the Eurozone Debt Crisis

The Eurozone debt crisis is now in its third year, and we want to share our perspective on recent developments. It now appears more likely than ever that Greece may exit the Euro currency, and you may be wondering how such a development would affect the markets and our approach to investing.

If Greece were to exit the Euro, it would likely default on its Euro-denominated debt and investors holding these securities would of course be affected. One of the primary holders of European sovereign debt is European banks. Most of the research we have read indicates that while Greece defaulting on its debt certainly would not be a welcome development for these banks, they could generally withstand it. The bigger problem for these banks would be if a larger sovereign issuer such as Spain or Italy were to default on its debts or if a Greece default triggered defaults by other sovereign governments, banks or corporations. While this cannot be ruled out over the longer term, there is nothing now that suggests that either Spain or Italy is on the verge of defaulting or leaving the Euro currency.

It's important to note that the high-quality bond funds and money market funds we use essentially have minimal-to-no exposure to the most troubled countries or banks. Also, while international stocks have recently underperformed U.S. stocks, we are content with the degree of international stock diversification in client portfolios. The U.S. makes up only about 45 percent of the world's equity markets, so a sizable allocation to international stocks is needed to have a well-diversified stock portfolio.

Lessons From the Debt Crisis

The primary lesson from this crisis — and all others — is that financial markets are and always will be risky. While this may sound scary, there is actually an important silver lining: Without risk, there would be no reward. One of the reasons the world's equity markets have provided high long-term returns is because investors face risks such as the current crisis. Over the long term, the world's equity markets have outperformed short-term bonds by nearly 6 percent per year, surviving World War I and II, numerous other "smaller" conflicts, the Great Depression, the inflation and oil price increases of the 1970s and 1980s, and 9/11.

Investors should also remember that keeping greed and fear in check are keys to achieving a successful investment outcome. In general, investors continue to exhibit "buy high/sell low" behavior by moving out of riskier investments after they have underperformed instead of developing an approach that meets their ability, willingness and need to take risk and sticking with it unless life circumstances change.

Many investors are likely making the same types of mistakes they made the last time interest rates were low: trading safer fixed income for riskier strategies they do not fully understand. The search for higher yield has led many investors to substitute high-quality fixed income for strategies such as high-dividend stocks and high-yield fixed income, which do have higher expected returns but have risk characteristics that are more similar to stocks than high-quality fixed income. Remember that even in an environment with low interest rates, high-quality fixed income remains the best way to reduce the overall risk of a portfolio.