

## "Deflecting Deflation Doomsday"

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The Asian financial crisis has raised the specter of a worldwide financial collapse. With the economies of various countries in Asia toppling like dominoes, and then their financial markets ricocheting off of European markets and even making our financial markets jumpy, we are confronted with the reality that the world has shrunk. More and more financial markets have become global, for better and for worse.

The last serious round of deflation in this country was, of course, the Great Depression, which most people alive today don't remember. But Japan, the world's second largest economy, has been dealing with severe deflation for the past five years. How would deflation affect you? Ask yourself what the impact would be on your portfolio if the U.S. experienced in the next five years what has happened in Japan over the last five years:

1. The stock market drops 60% from about 8000 (where it stood at the end of 1997) to 3000;
2. The real estate market collapses, with homes selling at less than half of what they sell for now...when they sell;
3. Interest rates drop to 1%.

This is what has happened in Japan, and now it is spreading to other Asian countries. Can it happen here? How can you protect yourself?

Of course we will now hear from many of the "doomsday crowd" that collapse is just around the corner. While this can happen, I suggest that you should guard against overreaction. The conditions which feed deflation simply are not evident in our country, at least not to the same extent as in Asia. Deflation in Asia is primarily caused by overpriced assets being repriced. The overpricing was caused mostly because loose credit policies enabled speculators to run up the price of real estate, stocks, and other assets. The Asian culture, which emphasizes relationships, contributed to the problem because the bankers did not want to confront their friends and so many non-performing loans were extended each year.

While some parallels can be drawn with the American situation, the deregulation agony that we went through in the 1980's has prevented the credit markets from feeding asset inflation. Some insist that we are on the brink of deflation because our stock market is grossly overpriced based on historical P/E ratios. But it can also be argued, persuasively I think, that the old measures aren't adequate to reflect what is going on in our economy today, such as the incredible advantages U.S. companies have gained by innovation, computerization and globalization. These intangible assets don't show up on our balance sheets.

That having been said, it would be folly to disregard the potential for worldwide financial disruption. After all, our money is basically just pictures of dead presidents; since the dollar is not backed by gold or other hard assets, its value is completely dependent on our faith in the system. Our own history as well as the current Asian experience has shown how quickly that confidence can evaporate.

The Cambridge System utilizes an approach which I developed called "Functional Asset Allocation." This asset allocation concept (which is comparable to the first known asset allocation strategy model promulgated by the Talmud) focuses on the basic functions of the three basic asset categories. These categories are: Interest Earning (such as bonds and cash); Real Estate; and Equities. Properly balancing your assets across these three asset categories is the key to protecting your net worth through any business cycle.

One of the functions of Real Estate, for example, is to protect you in inflationary times. Leveraged real estate (like the mortgage on your home) is the best inflation protection you can have if you have a fixed rate of interest. The function of Equities is to provide growth during periods of prosperity; it is the engine that has enabled many families to greatly increase their net worth over the past decade. Finally, the key function of the Interest Earning category is capital preservation. This is what protects you during deflation, by providing a reliable cash flow while keeping your investments safe.

We divide the Interest Earning category into three asset classes:

1. Cash and cash equivalents, (maturing in less than 18 months) which has to be at least sufficient to cover your cash flow needs for 1-2 months;
2. Tax-sheltered cash equivalents, which we call "Emergency Cash" which could be used for cash flow if, e.g., you became unemployed or disabled (which would cause your tax bracket to drop); and
3. Bonds, which mature in 18 months to 30 years.

It is important to understand that Interest Earning investments carry two types of risk: the risk of default (i.e. that the issuer will go bankrupt), and interest rate risk. The value of bonds decreases when interest rates go up. For instance, if you invest in a \$10,000 bond at 7% and then interest rates increase to 9%, you will not be able to sell your bond for the \$10,000 you paid (although you will get the full \$10,000 back when the bond matures, if the issuer doesn't go broke). Conversely, if interest rates drop after you buy a bond, you could sell it for a profit (before it matures). Because of this additional risk, usually bonds pay more interest (a higher yield) than cash.

The advantage of cash equivalents is that they are "liquid," which means they can be converted to cash quickly and without risk of loss of capital.

Bonds, in contrast, are "marketable" which means they can be converted to cash quickly but there is a risk of loss (if interest rates have risen, or the issuer has become insolvent). Bonds are the best way to guard against deflation, because they provide a fixed rate of interest over a long period of time as well as promise a full return of your investment (unlike stocks). Bonds are issued by corporations as well as municipalities and the U.S. Treasury. Corporate bonds have the best yield (i.e. interest as a percent of your investment), and "junk bonds" which are issued by companies with impaired credit ratings have the highest yields of all. Right now corporate bonds are yielding 7-9%. Municipal bonds have the advantage of being exempt from federal tax as well as state tax in the state of issue. So although they have a lower yield (3-5%) they are tax-free.

We often recommend U.S. Treasury Bonds for our clients. Although these have the lowest yield, now about 5-6%, interest is exempt from state taxes. The reason that the yield is so low is simply because they are absolutely the safest investment in the world. The U.S. Government could default, but if it does, it is likely to be the last one to go under.

There is another very significant advantage to U.S. Treasury Bonds: they are "non-callable." Corporate and municipal bonds have a provision that the issuer can pay off the bonds early and buy them back. So if interest rates drop, they just issue a new round of bonds at the lower rate and then pay off their outstanding bonds with higher rates. So if you buy a 20 year corporate bond with a 9% yield, you don't have a guarantee that you will get that rate for the whole 20 years. You can bet that if rates drop to 4-6% over the next 5 or 10 years, your bond will get called.

In the late 70's many clients bought municipal bonds with yields of 14-20%; these have all been long since "called" and paid off. But those savvy clients who bought 30 year U.S. Treasury Bonds (these are called "long bonds"), with a 12% yield are still getting their 12% and will continue to get it for the full 30 years!

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This is why U.S. Savings Bonds issued prior to 1994 (?) are now so valuable (see related story). Many of these bonds have a "floor" which guarantees 6% interest, while the "long bond" now is yielding 5.75%.

So if you are concerned about deflation, set up an appointment with your Cambridge Advisor to discuss utilizing U.S. Treasury Bonds in your portfolio. With the new tax bill, it is often advisable to put these in your qualified pension accounts (e.g. I.R.A.'s). Don't over-react to deflation fears, but your portfolio needs to be updated every year to adjust to a changing world!

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