Dimensional

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Sovereign Debt and the Equity Investor

Weston Wellington, Down to the Wire
Vice President

Last week we came across an "Economic and Policy Watch" update prepared by a major investment bank that reviewed recent government proposals to address the nation's funding crisis. Titled "It Just Gets Worse," the report chided policymakers for actions that "look like a poor cover for loose money, rising inflation, and fiscal problems," and warned that "government financing needs are corrupting monetary policy." As a result of these ill-advised tactics, the bank had turned "more negative" on the outlook for financial stability and saw "little hope of improvement in the inflation/currency mix."

Amidst the barrage of news coverage from dozens of sources probing the US debt/default/downgrade issue, such a conclusion might seem unremarkable. We found it of interest because the focus of the report was not the US Treasury but the government of Indonesia, and it appeared over a decade ago, on July 16, 2001.

Indonesia's sovereign debt rating at that time placed it firmly in the "junk" (non-investment grade) category: B3 from Moody's and single-B from Standard & Poor's. Although Moody's upgraded Indonesia to a B2 rating in 2003 and to Ba1 in early 2011, at no time over the past decade was Indonesia deemed to merit an investment grade rating.

What has been the experience of equity investors in Indonesia since this report was published? The Jakarta Composite Index closed at 415.09 on January 16, 2001, while the Dow Jones Industrial Average finished that day at 10,652.66. On Wednesday, the Jakarta Composite closed at 4,087.09 and the Dow at 12,592.80. If the Dow Jones Average had kept pace with Indonesian stocks over the past decade, it would be over 104,000 today.

Investors in Indonesia have had their share of ups and downs over the years, and markets fell even harder than the US during the financial crisis, with a peak-to-trough loss of nearly 60%. But the recovery was sharper as well: The Jakarta Composite recouped all of its losses by April 2010, and the all-time high on July 22 this year was 45% above the high-water mark of early 2008.

For the ten-year period ending June 30, 2011, total return as computed by MSCI was 29% per year in local currency and 33% in US dollar terms. At no point throughout this period did Indonesia have an investment grade rating for its sovereign debt, and outside observers continue to find fault with the country's troublesome level of corruption, primitive infrastructure, and unpredictable regulatory apparatus.

We are not suggesting that investors should dismiss the effects of a US government credit downgrade. US Treasury securities are so widely held around the world that any potentially destabilizing event is worrisome. Nor are we suggesting that investors focus solely on countries with low credit ratings. Just as a broadly diversified portfolio includes companies with high and low credit quality, investing in countries with both high and low ratings is equally sensible.

Some might say the strong performance of Indonesian stocks over the past decade was at least partly attributable to the nation's improving credit profile, even if it remained at a relatively low level. The US, in contrast, appears to be deteriorating. Our point is that a low credit rating in and of itself is not necessarily a death sentence for equity investors. Citizens of triple-A countries behave much like those living in single-B territory—they eat, drink, shop, get stuck in traffic jams, chatter on mobile phones, and check their Facebook pages. (Indonesia claims the second-largest number of members in the world.) Companies doing business in either location generate cash flows, and investors do their best to evaluate what those cash flows are worth. A triple-A sovereign debt rating is no guarantee of superior equity market returns, and a "junk" rating is no assurance of failure. A diversified strategy will have exposure to both.

Research assistance by Victoria Choi.

Ray Farris, "It Just Gets Worse," ING Barings *Economic and Policy Watch*, January 16, 2001.

"Global Credit Research," *Moody's Investors Service*, March 2004.

"Missing BRIC in the Wall," *Economist*, July 21, 2011.

Securities data provided by Bloomberg.

Yahoo! Finance, finance.yahoo.com (accessed July 25, 2011).