Dimensional

DIMENSIONAL FUND ADVISORS | Special Posting

The Eurozone and Greece: A Client Update

June 2012

Events in the Eurozone, particularly Greece's future participation in the currency union, have been the overwhelming focus of investors worldwide in recent months.

Naturally, many clients are asking about Dimensional's exposure to the countries at the center of the crisis, the protections we have in place, and how we would respond if events deteriorated from here.

This brief paper provides answers to these questions and places them within the context of our calm, disciplined, and risk-aware processes.

In doing this, we reaffirm our belief that basing investment decisions on forecasts is counter-productive—something even more true in such a rapidly developing and multi-stranded story. As always, news is quickly reflected in prices and there is little to be gained from speculating about likely outcomes.

Special Posting

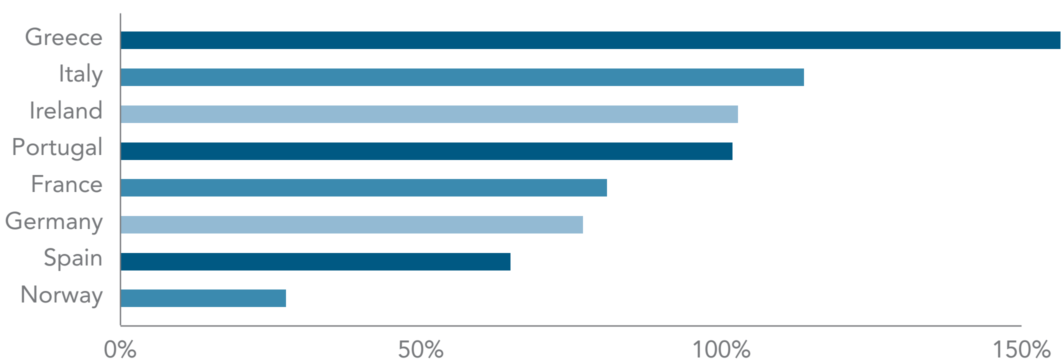
OVERVIEW OF THE CRISIS

The current crisis is a complex, multi-faceted, and constantly evolving story. But at its heart is concern over sovereign debt burdens in the Eurozone—an economic and monetary union of seventeen countries that adopted the euro as its common currency in 1999.

The Eurozone consists of Germany, Austria, France, Belgium, Luxembourg, Spain, Portugal, Italy, Greece, Cyprus, Ireland, Malta, the Netherlands, Slovakia, Slovenia, Finland, and Estonia. Another ten members of the wider European Union are not part of the single currency zone. So far, the Eurozone crisis has focused on a handful of countries—particularly Greece, Ireland, Italy, Spain, and Portugal.

At its heart, the volatility in markets globally reflects worries over the capacity of European policymakers, despite a succession of bailouts, to deal effectively with the debt legacy while holding the currency union together.

GOVERNMENT GROSS DEBT TO GDP (2011)



Source: Eurostat.

The possibility of Greece leaving the Eurozone, triggering a string of sovereign defaults, has been the focus of the markets' recent attention. While a rerun national election in Greece on June 17 provided hope of a positive outcome, uncertainty remains at high levels.

Outside the sovereign debt issue, there is also concern about the impact of the crisis on the Eurozone banking system. Refinancing by the European Central Bank in early 2012 provided short-term relief for the banks, but market pricing points to worries over the longer-term solvency of many institutions.

However, this crisis is as much a political as an economic affair. Austerity programs imposed in several countries as conditions for repeated bailouts from the European Union and the IMF have sparked social and political unrest. Elected governments are torn between their responsibilities to creditors and the anger of some of their taxpayers who do not wish to pay for what they see as the profligacy of bankers and politicians.

Meanwhile, Europe's inability to deal conclusively with its problems is creating international tension as governments elsewhere voice concern about the impact of the crisis on global economic growth. Germany, the most powerful economy in the Eurozone, is accused by its critics of pushing austerity at the expense of the growth needed for the peripheral countries to pay back their debt.

BACKGROUND ON GREECE

In relative terms, Greece is a very small economy. According to an IMF list of the world's economies ranked by size (GDP in purchasing power parity terms), it is 42nd, below Chile and above the Czech Republic.

However, Greece's public debt is large at around 160% of GDP. Athens has received a total of US$300 billion in bailouts from the IMF and the EU, the latest US$160 billion payment on the condition of imposing austerity measures to reduce debt to 120.5% of GDP by 2020.

In March, Greece avoided an uncontrolled default on its obligations by agreeing to a bond swap with private creditors. Still, after five years of recession, there does not appear to be much public support for further cutbacks. Amid this backlash, national elections on May 6 failed to yield a definitive outcome.

A run-off poll on June 17 provided a clearer outcome, with the two largest pro-bailout parties (the centre-right New Democracy and its traditional opposition the Socialist Pasok party) winning enough seats to form a parliamentary majority. This provided some immediate reassurance to markets. Even so, the incoming government still has to convince official lenders of its capacity to push through required reforms before securing further bailout funding.

For their part, European governments have indicated a willingness to adjust the terms of the bailout as long as a new government "swiftly" emerges. And central bank officials from leading developed economies are quoted by Reuters as saying they stand ready to flood the financial system with cash on any credit squeeze.

So even after the latest elections, there are still a lot of unknowns around the future of Greece in the euro and the capacity of European policymakers to hold the single currency together. Some market participants have speculated on Greece holding on, others predict a complete break-up of the euro, while still others believe a smaller union will emerge, built around Germany, France, Italy and Spain.

It should be noted that this information is merely provided as background and context. The final outcome—and perhaps more important, the process that it will take to get to that stage—is still not certain. However, all these possibilities should be incorporated in market prices.

It is what happens next that counts—and no one knows the answer to that question. So our approach remains the same.

DIMENSIONAL'S POSITION

Dimensional's Investment Committee has been monitoring the situation in Greece, together with our Portfolio Management and Trading teams.

In particular, the teams have planned a course of action and assessed potential impacts should a Greece exit from the Eurozone occur. In this event, our Investment Committee would review Greece's status in our portfolios and consider changing its trading status.

Even so, the fluidity of the situation means the committee could change Greece's trading status at any time. The review procedure is an independent process. We review countries on an ongoing basis and not on a set timetable. While information gathered in the market and official announcements are considered, the committee may rule on a country's eligibility based on our internal research.

In a previous meeting, the committee suspended purchases in Greece for all equity portfolios. This was due to uncertainty over whether Greece will retain its developed market status in our strategies, as well as potential operational risks associated with equity and currency trade settlement in the event of a Eurozone exit.

Greece is a small country by market capitalization and therefore generally makes up a relatively small portion of portfolio holdings within our equity strategies where it was eligible for investment. For example, as of May 29 for those strategies holding Greek equities, Greece's weighting ranged from less than 2% of portfolio assets in a European-only strategy to less than 25 basis points in a global equity strategy. In fixed income, Greece is not and has not been an eligible country for our strategies, so a review is not required.

Meanwhile, we continue to consult our relevant counterparties, including custodians, brokers, and middle office providers, regarding trading conditions in Greece and their contingency plans should a change in currency occur.

Our portfolio management and trading systems are designed to be adaptable and have been modified in the past to accommodate new investment strategies, enhancements in existing strategies, and changes in markets. We have been conducting a review of those systems should any changes to currencies be announced.

WIDER MARKET PERSPECTIVE

While parallels have been drawn between this phase of the Eurozone crisis and the Lehman Brothers collapse of October 2008, measures of stress in equity and money markets are far below the levels seen during that period.

One equity measure is the Chicago Board Options Exchange's "Volatility Index." Sometimes known as the "fear index," this is a barometer of the market's estimate of future volatility of the US equity market over the coming thirty days.

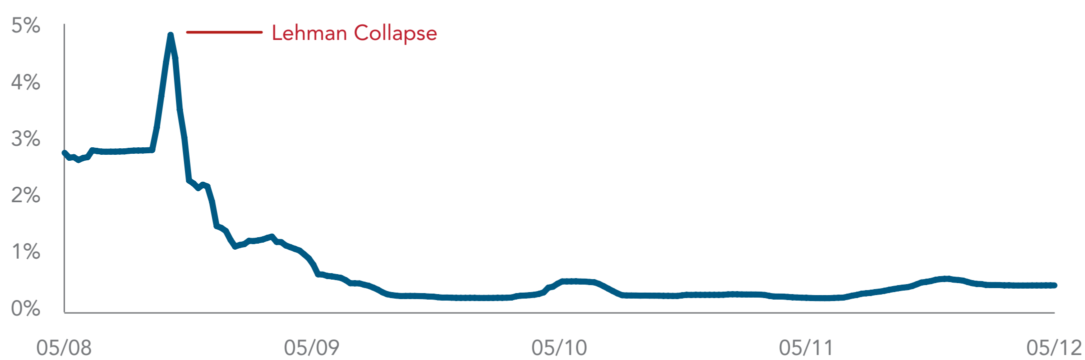
The chart below shows the index has been hovering around the low to mid-20s in recent weeks, significantly lower than its 2008 peak levels near 80.

VOLATILITY INDEX (VIX)

Source: Bloomberg.

In the credit markets, a closely watched barometer of stress is the three-month London Interbank Offered Rate, or LIBOR. This refers to the interest rate banks charge each other in the wholesale money markets in London for ninety-day loans.

LIBOR RATES ($US, 3-MONTH)



Source: Bloomberg.

Leading into the Greek election, the three-month US dollar LIBOR was around 0.47% and had been steady at those levels for twenty consecutive sessions. In comparison, LIBOR was at more than 4.0% in October 2008.

Another measure of sentiment is the credit default swap market. Credit default swaps (CDSs) are a form of derivative that allows investors to take out insurance against a loan default. There are CDSs for corporate and sovereign borrowers.

Greek CDSs have been prevented from trading since early March after breaching a technical provision. However, even after the removal of that obstacle in the past week, most dealers have refused to renew quoting them due to the uncertainty around the vote.

The pricing of other Eurozone CDSs moderated earlier this year as refinancing agreements were reached, but they have since returned to near the elevated levels of December. The most marked deterioration has been for Spain, whose swaps have blown out by more than 200 basis points since the start of the year to just over 600 basis points.

In this case, risk measures are much higher than in 2008 when most of the focus was on the banking system rather than on sovereign debt.

But this is also another way of saying that much of the bad news is already in the price.

SUMMARY

Nearly three years since it began, the European sovereign debt crisis continues to create great uncertainty in global financial markets.

This is understandably an anxious time for investors. The crisis has raised questions about not only the sustainability of sovereign debt burdens in Europe, but about the future of the common currency experiment.

At a wider level, investors globally are expressing concern about the impact of the crisis on economic growth rates and the financial system itself.

However, as we have seen, the extent of uncertainty—as expressed in market prices—is nowhere near the levels reached during the Lehman crisis of late 2008.

It is also worth noting that policymakers in the major economies, both inside and outside Europe, have made contingency plans to ensure liquidity is made available in the event of any future strains in credit markets.

On Dimensional's part, our senior investment team is closely watching developments and stands ready to review the status of Greece and other Eurozone participant countries should the circumstances merit it.

We have zero exposure to Greek government debt, as Greece is not eligible for our fixed income strategies. Our exposure to Greek equities is minimal, and we have suspended further purchases in that country for the time being.

We understand the anxiety of clients at this time. Like you, we do not know what the future holds. But we do know that markets incorporate all known information and that the widespread anxieties are already reflected in prices.

Finally, you can be confident that our disciplined investment processes, the flexibility of our approach, and the quality of our investment team position us extremely well to continue to manage our portfolios in the best interests of clients.

We are always happy to answer your questions and stand ready to provide any further clarification you need.
