

# BROWN BROTHERS HARRIMAN InvestorView

INSIGHTS AT THE INTERSECTION OF WEALTH, FAMILY, AND VALUES



Everything You Ever  
Wanted to Know About  
**Debt and  
Deficits**  
(But Were Afraid to Ask)

Summer 2025



# InvestorView

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Dear clients and friends,

We're halfway through 2025, and the word of the year seems to be uncertainty. However, uncertain environments are not necessarily something to balk at. In our feature article, Partner and Chief Investment Strategist Scott Clemons tackles the twin challenges of rising U.S. debt and deficits, exploring five possible solutions and the implications of this debt for investors.

In another article, Partner and Chief Investment Officer (CIO) Justin Reed and Deputy CIO Ilene Spitzer provide a guide for investing in independent return strategies – a valuable source of returns amid market uncertainty. Meanwhile, Fixed Income Product Specialist Tom Brennan covers how to manage uncertainty in fixed income.

Finally, Senior Wealth Planner Alison Hutchinson and Chief Fiduciary Officer Melineh Ounanian outline ideas for how trust beneficiaries can learn more about their roles and responsibilities.

Please do not hesitate to reach out if you would like to discuss any of the topics covered in more depth. We hope you enjoy this issue and the rest of the summer season.

Best,



**G. Scott Clemons, CFA**  
*Partner*  
*Chief Investment Strategist*

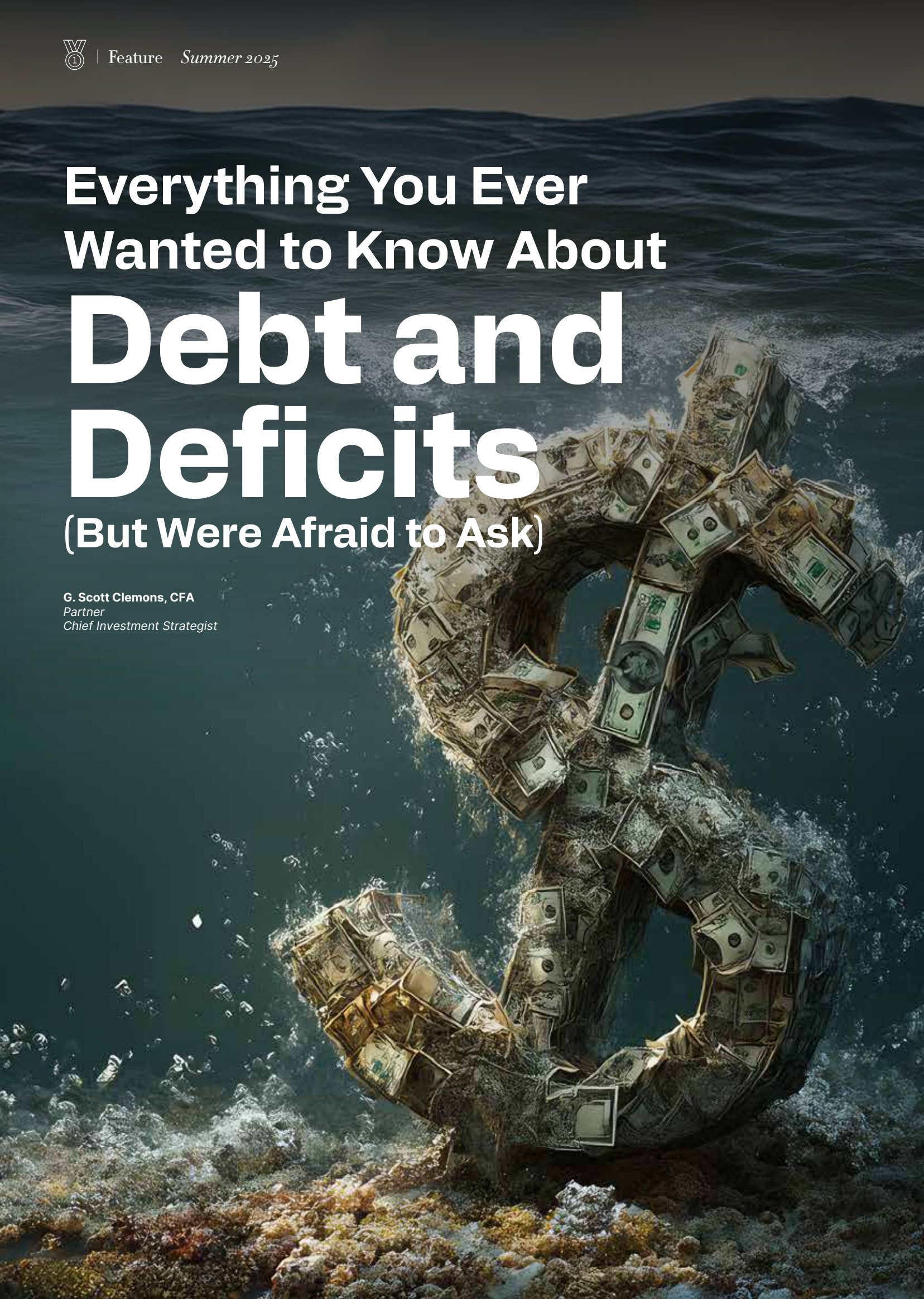


**Justin Reed**  
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# Everything You Ever Wanted to Know About Debt and Deficits (But Were Afraid to Ask)

G. Scott Clemons, CFA  
Partner  
Chief Investment Strategist





## A brief history of federal debt

If, as Benjamin Franklin once observed, the only certainties in life are death and taxes, then the corollary certainties of the federal government seem to be debt and deficits.

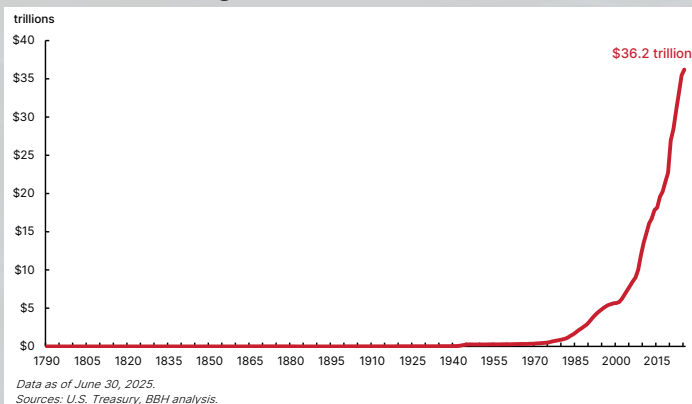
Our national dance with debt started early: The Continental Congress lacked the authority to impose taxes on individuals or trade, and therefore had no real choice but to finance the Revolutionary War with borrowed funds. Our young nation (even before it was technically a nation) first issued debt on June 22, 1775, just days after the Battle of Bunker Hill, when Congress sold \$2 million in short-term bills to support the war effort. The investors in this first debt issue were largely wealthy landowners, the French government (eager to destabilize its enemy England), and the Dutch government (always interested in expanding Dutch financial influence).

After the signing of the Declaration of Independence, Alexander Hamilton argued that the new nation should assume these debts previously incurred by the colonies, a contentious suggestion memorably dramatized in “Cabinet Battle #1” of Lin-Manuel Miranda’s musical “Hamilton.” Hamilton, our first secretary of the Treasury, understood how important debt was as the U.S. was establishing its economic footing as an independent nation:

*The United States debt, foreign and domestic, was the price of liberty. The faith of America has been repeatedly pledged for it ... Among ourselves, the most enlightened friends of good government are those whose expectations of prompt payment are the highest. To justify and preserve their confidence; to promote the increasing respectability of the American name; to answer the calls of justice; to restore landed property to its due value; to furnish new resources, both to agriculture and commerce; to cement more closely the Union of the States; to add to their security against foreign attack; to establish public order on the basis of an upright and liberal policy; these are the great and invaluable ends to be secured by a proper and adequate provision, at the present period, for the support of public credit.<sup>1</sup>*

When Hamilton penned these words in the “First Report on the Public Credit” in 1790, outstanding federal debt totaled \$71,060,509. It’s risen a bit since then: As of June 30, 2025, federal debt stands at \$36,211,469,351,821.30. That’s a little over \$36 trillion for those who easily lose track of so many commas.

## Total outstanding U.S. federal debt



The nearby graph illustrates in graphic (and alarming) detail how rapidly our gross national debt has risen over the past 50 years. Total debt first crossed above \$1 trillion in 1982, passed the \$10 trillion mark in 2008, hit \$20 trillion in 2017, and exceeded \$30 trillion by the end of 2022. The Congressional Budget Office (CBO) projects that we will pass \$40 trillion of debt by the end of 2027. To be precisely fair, some of this debt represents intra-governmental loans, such as surpluses held by the Social Security trust fund, or military retirement funds, and invested in Treasuries. As these loans represent perfectly matched assets and liabilities of the federal government, they should arguably be excluded from a consideration of true (net) public debt.

The good news is that these intra-governmental loans reduce the current total debt figure by almost \$7.3 trillion. The bad news is that this adjustment still leaves almost \$29 trillion of debt held by the public. Our situation is not meaningfully improved.

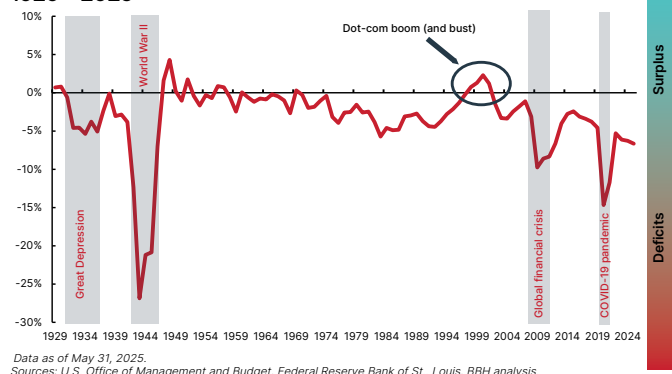
## The role of budget deficits

Total debt is a function of the cumulation of prior deficits. When a nation spends more than it takes in, the resulting deficit is financed through debt issuance. If debt is issued more rapidly than it matures, the national debt rises. The twin challenge of rising deficits and debt is often (and justifiably) conflated, but it is worth noting that one (deficits) leads to the other (debt) – an important distinction when it comes to considering how we might address the problem.

Our national addiction to debt is largely a result of our national addiction to deficits. The federal budget has posted a surplus in just 14 of the past 96 years, and only four of the past 50 years, when the merger and acquisition activity associated with the dot-com boom led to a sharp rise in tax revenues from 1998 to 2001.

<sup>1</sup> “First Report on the Public Credit,” 1790. Alexander Hamilton. <https://teachingamericanhistory.org/document/first-report-on-public-credit/>

**U.S. budget balances  
1929 - 2025**



Deficits understandably deepen in periods of economic or national emergency, such as recessions or war, as federal spending rises to meet spending needs that the private sector can't fulfill. As an extreme example from history, the war effort in the 1940s ballooned the deficit out to a record of 27% of gross domestic product (GDP) in 1943, but fiscal austerity following the war returned the budget to a surplus by 1947. Between World War II and the global financial crisis (GFC), the budget deficit averaged about 1.5% of GDP, worsening during recessions, but generally improving once economic conditions improved.

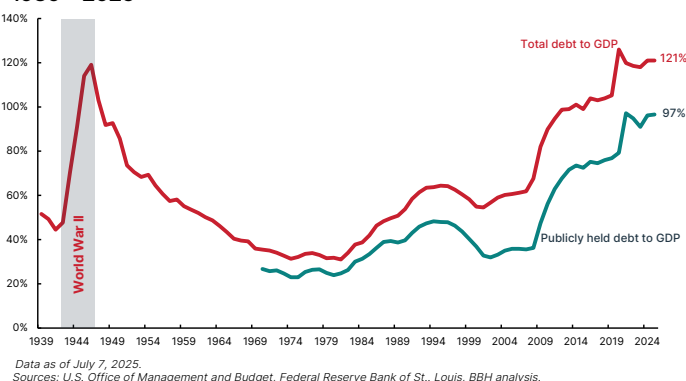
The renewed attention to debt and deficits is due in no small part to the fact that the cyclical nature of budget deficits and surpluses seems to have foundered over the past few decades, or, perhaps more accurately, remained cyclical around a worsening secular trend. The federal budget balance dropped to almost -10% during the GFC, but only recovered to -2.4% in 2015, before plummeting again to -15% in 2020 due to pandemic-era fiscal stimulus. As of May 2025, the trailing-12-month deficit stands at 6.7%, an unprecedented level in U.S. history outside periods of recession or war.

## Debt to GDP

The previous consideration places deficits into the context of GDP, and it is only fair that we complete the historical survey by doing likewise with debt. After all, debt in a vacuum reveals very little about the financial health of an entity. Just as we might consider a ratio of debt to assets, cash flow, or EBITDA in assessing the financial health of a company, we should similarly compare a nation's debt to a measure of economic activity or "earnings." That measure for an economy is GDP, or the total annual economic output of a nation.

The historical dynamic in the nearby chart will be familiar by now. Debt to GDP rose sharply in the early 1940s as the U.S. geared up to fight a world war on two fronts, peaking at 119% in 1946. From that peak, debt to GDP fell steadily as military spending waned and the economy pivoted back to private enterprise. For the record, the post-war trough was a debt-to-GDP ratio of 31% in 1981.

**U.S. debt to GDP  
1939 - 2025**



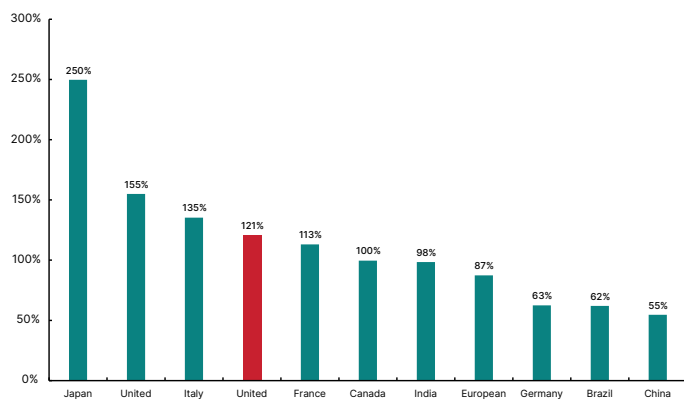
The gross debt-to-GDP ratio has come full circle some 75 years after the end of World War II, to stand at 121% as of mid-2025, slightly down from the pandemic peak of 126%, but above the peak spending associated with World War II. Adjusting this ratio to remove intra-governmental debt (discussed earlier) lowers the ratio to 97%, a directional improvement, but not one that solves the underlying problem of a rapidly rising trend. Regardless of whether we calculate this ratio on total (gross) debt or only the (net) debt held by the public, both the direction and level of this graph are increasingly worrisome.

And it's likely to get worse before it gets better. According to multiple analyses, the recently passed One Big Beautiful Bill (OB BB) will likely add around \$3.4 trillion to the deficit (and therefore debt) over the next decade. To be fair, the CBO was already forecasting trillion-dollar deficits for the next few years even before this legislation, so the OB BB doesn't bear the sole blame for the debt and deficit problem, although it is likely to exacerbate it. Note that the CBO projections also make no assumption about future economic cycles, so any slowdown in growth would amplify these deficits.

Conversely, supporters of the bill claim that these forecasts underestimate the boost to economic growth and therefore the tax revenues that the provisions of the bill will unlock, thereby lowering deficits and debt to GDP. And this may be right: We will see shortly that robust growth is one path out of the debt and deficit morass in which we currently find ourselves.

Before transitioning to the solution set, let us briefly broaden our view and place the U.S. situation into a global context. Ours is not the only economy to wrestle with the challenges of geopolitics, economic cycles, aging populations, rising healthcare costs, and the occasional national emergency. More mature economies with aging populations tend to have higher debt burdens: see Japan and Italy, in particular. Conversely, emerging economies with younger populations or less developed social infrastructure tend to have smaller debt-to-GDP ratios: see Brazil and China, for example.

## A global tour of debt to GDP



Data as of most recent release (2024 - 2025).  
Sources: National Statistical Agencies, BBH analysis.

At 121% of GDP, the U.S. debt level is not an outlier in the global scheme of things, but the trends outlined earlier indicate that unless we act, debt and deficits will become more and more of a problem.

## The solutions

U.S. economist Herbert Stein coined the humorous and ominous economic principle that bears his name. Stein's Law holds that "that which cannot go on forever will stop." Ironically, Stein first applied this principle to the very subject of debt and deficits as far back as 1986, when debt to GDP was a modest 46%, proving that although unsustainable trends must eventually come to an end, "eventually" can be a long, long time.

How might Stein's Law apply to our current circumstances? If this seemingly inexorable rise in debt and deficits is to end, what might that look like? We see five potential paths forward, none of which is mutually exclusive:

- The most appealing solution is **robust real economic growth**, which would allow deficits and debt to GDP to fall as economic growth accelerates.
- **Inflation** will likely play a role as well, as it mitigates the real debt burden by reducing the inflation-adjusted value of future debt payments.
- Fiscal solutions might involve simply **spending less money** or ...
- **Expanding revenue** through higher (or different) taxes.
- Finally, in the interest of making our solution set truly exhaustive, we must consider the possibility of **out-right default**.

To address our debt and deficit challenges effectively will almost certainly require a combination of these solutions, each of which warrants its own comprehensive analysis. In the pages that follow, we'll briefly review each in turn, and then conclude with a consideration of the implications for investors.

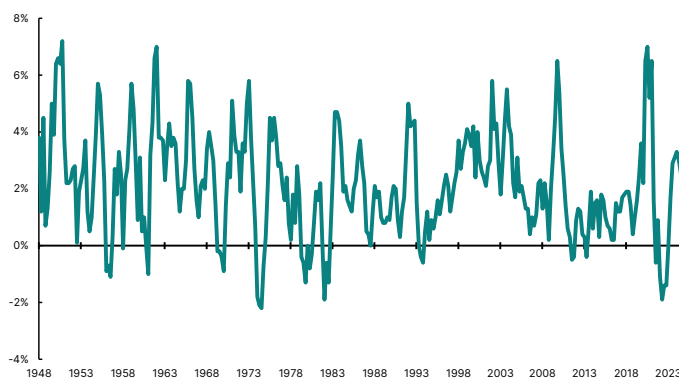
## Grow really fast

If we define our essential debt challenge not in absolute terms, but relative to GDP, then robust economic growth would cover a multitude of fiscal sins. Simply put, fast growth in the denominator of the debt-to-GDP ratio would solve the problem without the hard choices of spending less or raising taxes. This solution is alluring in its appeal, but, alas, easier said than done. Over the past 50 years, outstanding federal debt has grown at an annualized pace of 8.8%, implying that the economy would need to expand faster than that (in nominal terms) for growth alone to solve the problem. The economy has grown this fast for a quarter or two, almost always in a rebound from a recession, but never on a sustainable basis.

In the long run, economic growth is a function of two variables: growth in the labor force and productivity. Labor force growth is almost a fixed variable and has declined over the past few decades as birth rates have dropped. Other nations (China, notably) have tried to increase birth rates through policy, but to no avail. Policies of the current administration make it highly unlikely that immigration will help to boost labor force growth, so productivity and technology are all that is left.

History offers a curious lesson in the economic benefit of technology: The promise of productivity rarely translates into reality. Consider, for example, the introduction of computing technology into corporate America in the 1970s and 1980s. As businesses and individuals integrated computers into their professional and personal lives, the measurable impact on productivity was negligible, or even negative. The quarterly data shown in the nearby chart is noisy, but from the 1940s through the 1960s, productivity growth (measured as output per unit of labor input) grew at an average annual pace of 2.8%. As computers permeated the economy in the 1970s and 1980s productivity still grew, but at a more modest average pace of 1.7%.

### Annual productivity growth Output per unit of labor input



Data as of March 31, 2025.  
Sources: Bureau of Labor Statistics, BBH analysis.

This absence of measurable productivity gains prompted economist Robert Solow to wryly observe, "You can see the





# [F]ast growth in the denominator of the debt-to-GDP ratio would solve the problem without the hard choices of spending less or raising taxes. This solution is alluring in its appeal, but, alas, easier said than done.

computer age everywhere but in the productivity statistics.” This so-called “productivity paradox” has been explained away as a delayed benefit (productivity growth averaged 2.1% in the 1990s), or a mismeasurement, but the historical record speaks volumes that technology is not, or at least has not been, the panacea that the evangelists of Silicon Valley would have us believe.

The promise of artificial intelligence may very well make these historical examples moot. It is possible that we are on the precipice of an unprecedented boom in productivity and therefore economic activity. It would be imprudent, nevertheless, to rely solely on this promise of outsized GDP growth to solve our debt problems. Hope is not a strategy.

## Inflation

Note that we have so far written only in nominal terms, ignoring (up until now) the effect of inflation on these debt, deficit, and economic dynamics. We’ve done that in order to focus specifically on inflation as a potential “solution” for our debt challenge. We employ scare quotes here to underscore that the inflation isn’t an appealing approach to addressing our growing debt burden, particularly for investors.

Regular readers will be familiar with the miracle of compound interest: how a small amount of money can compound, even at a modest rate of interest, into a great fortune. Inflation is the evil twin of compounding. Inflation can turn a great fortune, even at a modest rate of inflation, into a small amount of purchasing power. Inflation is therefore a debtor’s best friend, as it reduces the real liability of debt over time.

This is not to argue that inflation would ever become the explicit policy of the U.S. government in an effort to reduce the debt burden, but benign neglect can go a long way. Yet interest rates provide a self-correcting market mechanism that responds to rising inflation rather quickly. If lenders (bond investors) conclude that the government or the Federal Reserve is growing complacent about inflation, they will demand higher rates of interest to compensate for this rising risk. This ultimately leads to higher debt service and deeper deficits, thereby exacerbating the very problem that inflation was expected to address. The law of unintended consequences is not subject to repeal.

Readers of a certain age will recall the “bond market vigilantes” of the 1980s (so named by economist Ed Yardeni). In this earlier era of rising debt and inflation, bond investors sought to influence government policy by selling (or refusing to buy) longer-dated bonds, thereby driving bond prices down and interest rates up. Whether this was an explicit and collusive intent of market participants or simply the aggregate outcome of individual investment decisions is irrelevant: Rising bond yields tend to focus the minds of politicians and central bankers alike. During one such period of sharply rising bond yields in the early 1990s, James Carville noted: “I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.”

Modest inflation is likely to remain one factor restraining the growth in the real burden of debt, but the market will provide painful discipline through higher interest rates if inflation fears escalate too much.

## Spend less

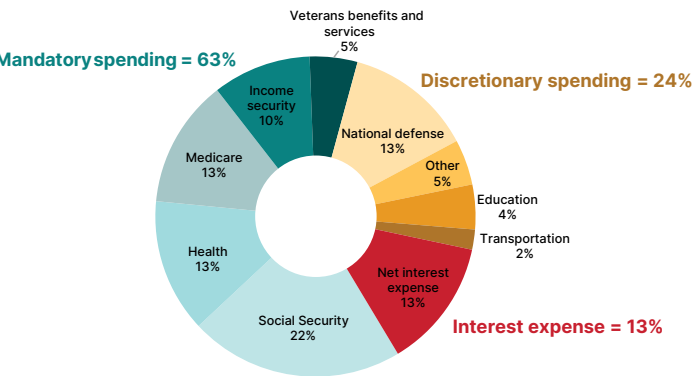
Here we are, deep into this commentary, and we finally come to perhaps the most obvious solution: If our national fiscal problem is a function of overspending, maybe we should simply spend less. As with the other solutions covered herein, cutting spending is easier said than done.

Government outlays fall into three categories:

- **Mandatory spending** is determined by existing law and is not subject to annual budget appropriations. This category includes Social Security, Medicare, Medicaid, federal military and civilian retirement plans, and veterans’ disability benefits, among others. This is not to say that this spending can’t be changed, only that cutting this category requires a change of law distinct from the annual budget process. As the nearby graph illustrates, mandatory spending accounts for almost two-thirds of annual federal government outlays.



Federal government spending  
Fiscal year 2024 (\$6.7 trillion)



Data as of May 2025.  
Sources: U.S. Treasury Monthly Treasury Statement, BBH analysis.

- **Discretionary spending** is easier to cut, as it is set by the annual budget process and does not require legislative change. This category includes defense spending, education, international affairs (such as USAID), government agency operating budgets, research and medical grants, community and regional development, and transportation. Discretionary spending represents 24% of total federal outlays.
- **Interest on the national debt**, the final category, is mandatory for all intents and purposes. In the last full fiscal year, debt service amounted to \$882 billion, or 13% of total government spending. Notably, interest expense last year exceeded spending on national defense for the first time in our history.

The challenge is painfully obvious: So much of federal spending is mandatory that cuts are hard to find. About 75% of government spending is locked in even before the annual budget process starts. The four big spending categories of Social Security, Medicare, Medicaid, and defense accounted for 61% of all spending in 2024, and this has been true for decades.

Peter Fisher, former undersecretary of the Treasury, once remarked that the U.S., at least financially, resembles a giant insurance company with an army. There seems to be little political will to make serious cuts in any of these categories, as politicians would no doubt pay a price at the ballot box come election day.

The Department of Government Efficiency (DOGE) under the leadership of Elon Musk learned these difficulties firsthand earlier this year. According to the department’s own website, DOGE has identified \$190 billion of savings as of June 29, 2025. This seems on first glance like a great deal of money. Leaving aside how much of this claim can actually be accomplished, this is equivalent to a mere 2.8% of the outlays detailed in the pie chart nearby. All else being equal, this would have reduced last year’s fiscal deficit from \$1.8 trillion to \$1.6 trillion. We should by all means identify and rectify waste, fraud, and abuse where it exists, but there is

not enough to make more than a dent in the size of our debt and deficits.

The DOGE experience raises another general point. We human beings are not naturally conversant in such large numbers. Many of us deal in millions, particularly in matters of finance or business. Trafficking in billions is rare territory, and unless you are an astrophysicist or molecular biologist, you almost certainly don’t deal with measurements in the trillions. It is easy to think subjectively that all of these units of measurement represent “really big numbers,” but they are vastly, vastly different.

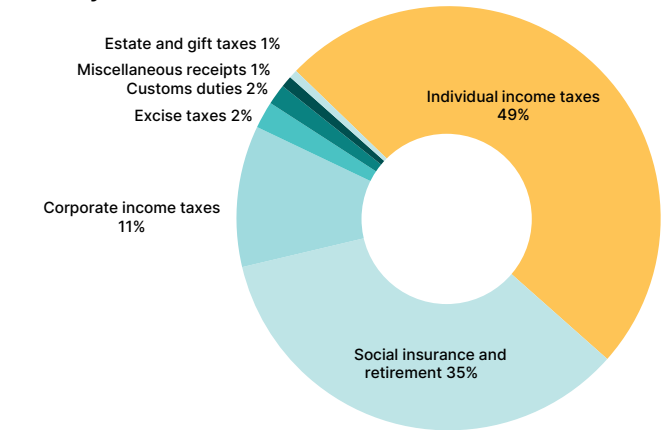
To illustrate the point, consider that a million seconds is about 12 days. A billion seconds ago, however, was 1993. A trillion seconds ago? The year 30,000 B.C. Saving millions – or even billions – in pursuit of a debt and deficit challenge measured in trillions is quixotic at best.

Make more

If spending less won’t get all the way toward our goal of fiscal prudence, maybe we should find ways to make more – that is, to increase the sources of federal income. Similar to what we saw with the analysis of government spending, a few categories account for the vast majority of receipts as well, which makes the task difficult.

By far the largest source of federal revenues is individual tax payments, followed closely by payroll tax payments into various social insurance programs (again, the dominance of Social Security, Medicare, and Medicaid in our national finances is evident). Corporate taxes amount to only 11% of total receipts, and all other sources of revenues (including customs duties, tariffs, and estate and gift taxes) are close to rounding errors. Note that the total for federal receipts in 2024 was \$4.9 trillion, compared to the \$6.7 trillion of spending detailed in the last few paragraphs. The difference of \$1.8 trillion is last year’s deficit.

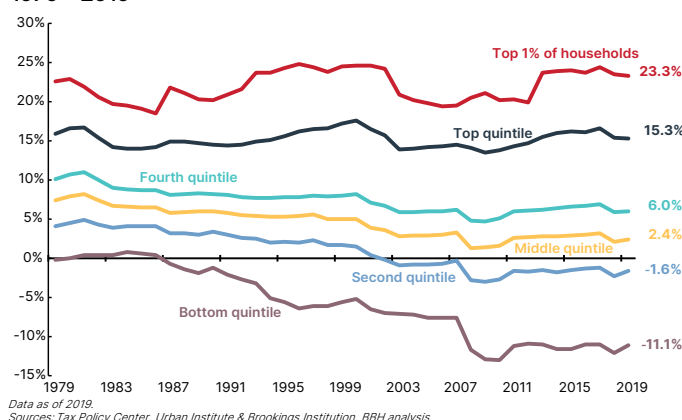
Federal government receipts  
Fiscal year 2024 (\$4.9 trillion)



Data as of May 2025.  
Sources: U.S. Treasury Monthly Treasury Statement, BBH analysis.

Let's focus on the largest category of individual income taxes and see if we can close this \$1.8 trillion gap through this revenue source alone. Our individual income tax structure is already quite progressive. The nearby graph illustrates the trend in effective (not statutory) tax rates by quintiles of household income, with the top 1% of households detailed in red. This data aggregates and averages individual income tax payments as a percentage of total income, so incorporates tax credits and deductions, but does not include payroll taxes. Note that the data extends only through the 2019 tax year, as the tax benefits associated with the pandemic wreak havoc with the data starting in 2020.

**Effective individual income tax rates by household income 1979 - 2019**

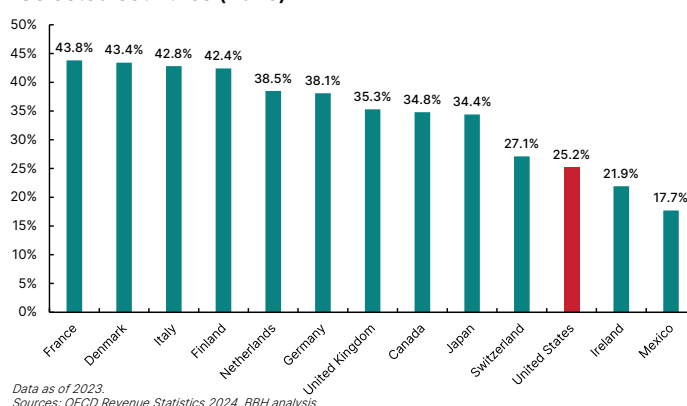


More than 40% of households (the bottom two quintiles in the nearby graph) have negative effective tax rates, due largely to benefits such as the earned-income tax credit and the child tax credit. The top quintile of households pays an average individual income tax of 15.3%, and the top 1% of households (making more than about \$800,000 per year, on average) pay an average rate of 23.3%.

Here again a simple calculation illustrates the intractability of the problem. The top 1% of U.S. households comprise roughly 1.3 million taxpayers, with average annual income of about \$780,000. If we were to tax all of this income at an effective (not marginal!) rate of 100%, it would generate revenues of a little over \$1 trillion, leaving the deficit \$800 billion in the hole. This is, of course, a Swiftian proposal. No one is proposing a tax hike to 100%, or, indeed, tax hikes at all given the recent passage of the OBBA.

Placing the U.S. tax experience into a global context offers an interesting avenue of inquiry. Comparing tax burdens across borders is difficult, because there are as many different tax regimes on the planet as there are taxing authorities, but at the highest level – and taking into account all forms of taxation, not just individual income taxes – the tax burden in the U.S. relative to GDP is relatively modest.

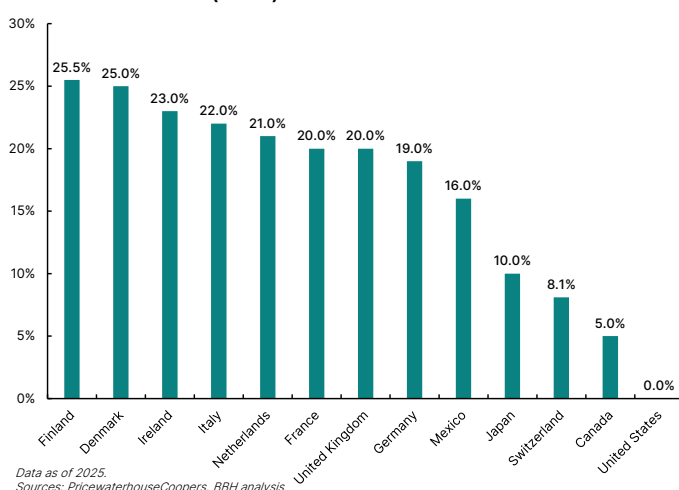
**Tax revenue as a percentage of GDP Selected countries (2023)**



This graph won't surprise most readers. Europe (and the Nordic countries, in particular) is known for imposing higher taxes on just about everything. Tax revenues to GDP in Canada are almost 10 percentage points higher than in the U.S., and in the nearby graph, only Ireland and Mexico have lighter tax burdens relative to the size of the economy than we do in the U.S. (For the record, Turkey, Chile, Colombia, and Costa Rica also have lower tax burdens than the U.S. relative to GDP.)

There is a simple reason for this apparent disparity in tax burdens. Every country on this graph except the U.S. has a national value-added tax (VAT) or a goods and services tax applied to consumption. Indeed, 175 countries and over 90% of the world's population live with a national consumption tax. The U.S. is an outlier.

**National consumption tax rates Selected countries (2023)**



Herein lies an intriguing thought experiment. Personal consumption is the largest driver of economic activity in the





U.S., amounting to more than \$20 trillion over the past year. A 10% VAT applied to this level of consumption would generate around \$2 trillion of tax revenue, all else being equal, more than covering our current level of deficit. Furthermore, a national consumption tax at this level would still leave us far below similar consumption taxes applied elsewhere in the world.

As with so much else in this article, this is easier said than done. The math and economics work all day long, but politics is a different matter. Many states and cities already have sales or use taxes. Would a national tax supplant those existing taxes or be incremental? The cost of compliance is meaningful at the point of sale, although other countries have figured it out, and technology should mitigate this challenge. From a social standpoint, perhaps the biggest obstacle is that consumption taxes are regressive: Poorer households bear a greater burden relative to income than wealthier households.

Yet the point remains: Leaving aside the societal issues of a more regressive tax regime, if we need to substantially raise revenues, a broader tax base such as that offered by a consumption tax fits the bill.

Default

None of the challenges outlined in these pages is new. As long ago as August 2011, Standard & Poor’s referenced them in lowering the U.S. sovereign debt rating to AA+ from AAA: “Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising U.S. public debt burden in a manner consistent with a ‘AAA’ rating and with ‘AAA’ rated sovereign peers.”<sup>2</sup> This downgrade took place almost 15 years ago, in the wake of the GFC and as Congress played one of its regular games of economic chicken with the debt ceiling.

It took some time, but Fitch followed suit with a rating downgrade from AAA to AA+ in August 2023, and Moody’s rounded out the trifecta by lowering its rating of the U.S. from Aaa to Aa1 in May 2025. Moody’s noted that the downgrade “reflects the increase over more than a decade in

government debt and interest payment ratios to levels that are significantly higher than similarly rated sovereigns.”<sup>3</sup> The press release went on to observe that:

*Successive US administrations and Congress have failed to agree on measures to reverse the trend of large annual fiscal deficits and growing interest costs. We do not believe that material multi-year reductions in mandatory spending and deficits will result from current fiscal proposals under consideration. Over the next decade, we expect larger deficits as entitlement spending rises while government revenue remains broadly flat. In turn, persistent, large fiscal deficits will drive the government’s debt and interest burden higher. The US’ fiscal performance is likely to deteriorate relative to its own past and compared to other highly-rated sovereigns.*

Selected sovereign debt ratings

Country	S&P	Moody's	Fitch
Canada	AAA	Aaa	AA+
Denmark	AAA	Aaa	AAA
Germany	AAA	Aaa	AAA
Netherlands	AAA	Aaa	AAA
Switzerland	AAA	Aaa	AAA
United States	AA+	Aa1	AA+
Finland	AA+	Aa1	AA+
United Kingdom	AA	Aa3	AA-
Ireland	AA	Aa3	AA
France	AA-	Aa3	AA-
Mexico	BBB	Baa2	BBB-

Data as of July 10, 2025.  
Sources: S&P, Moody's, Fitch, BBH analysis.

Nothing in these downgrades speaks explicitly of default, and the U.S. remains one of the highest-rated sovereign debt issuers on the planet, bested only by Canada, Denmark, Germany, the Netherlands, and Switzerland. The real import

<sup>2</sup> “United States of America Long-Term Rating Lowered to ‘AA+’ Due To Political Risks, Rising Debt Burden; Outlook Negative.” August 2011. Standard & Poor’s. <https://www.spglobal.com/ratings/en/regulatory/article/-/view/type/HTML/id/883558>  
<sup>3</sup> “Moody’s Ratings downgrades United States ratings to Aa1 from Aaa; changes outlook to stable.” May 2025. Moody’s Ratings. <https://ratings.moody.com/ratings-news/443154>

of these downgrades is to sound the alarm that, unless addressed, debt and deficits can rise to the point that default does become more likely, and that somewhere out there is a tipping point at which the options outlined in this piece are no longer available. At that undefined point, some sort of default becomes inevitable.

Financial markets provide some transparency into the waning and waxing of sovereign risk through credit default swaps (CDS), which allow investors to insure against the possibility of default. Swap spreads rise with anxiety, and trends over time illustrate aggregate market sentiment toward individual issuers. In the nearby table, the figures represent in basis points (bps)<sup>4</sup> how much it costs to protect against the default of a sovereign issuer. A simple way to read the table is that the number in the second column represents how many dollars it currently costs to hedge \$1 million of underlying value. For example, to hedge a \$1 million five-year U.S. government bond costs a little over \$40 per year at present.

**Selected sovereign credit default swap rates**  
(Basis points)

Country	Five-year CDS
Argentina	830.6
Turkey	284.8
Mexico	103.6
Greece	48.3
Italy	45.1
United States	40.7
France	35.6
Canada	23.9
Japan	20.7
Ireland	20.5
United Kingdom	18.0
Finland	17.4
Netherlands	11.5
Sweden	11.5
Denmark	11.1
Switzerland	10.6
Germany	9.8

Data as of July 10, 2025.  
Source: Bloomberg, BBH analysis.

CDS in the U.S. have ranged from a low of about 10 bps to a high of around 80 bps over the past few decades, indicating that anxiety about U.S. sovereign credit rises and wanes from time to time, but remains at a generally low level.

We typically associate sovereign defaults with spectacular economic collapse, social unrest, and political upheaval, but default need not be binary. There are variations on the theme, and rising default risk in the U.S. will more likely present itself as rising inflation and a weaker dollar. Inflation is itself arguably a soft form of default, albeit not in a contractual sense. Repaying debts with devalued purchasing power might not violate the legal terms of a bond contract, but it does seem to violate some sort of social contract.

There are examples throughout history of stronger forms of default, such as forced swaps. Greece in 2012, Argentina in 2005, and Ecuador in 2008 all forced bond holders to exchange their current bond holdings for newly issued debt with lower par values, lower interest rates, or longer maturities. Any of these changes represents a unilateral change to the terms of a contract. Of course, owners don’t have to accept a swap offer, but they are faced with the legal and opportunity costs of lengthy court battles.

A form of soft default has actually happened before here in the U.S.: During the Great Depression, newly elected President Franklin Roosevelt took the U.S. off the gold standard, and at the same time changed existing bond contracts to nullify the obligation to satisfy bond holders in gold. Bonds at the time carried the promise that the “principal and interest hereof are payable in United States gold coin of the present standard of value.” President Roosevelt (and the 73rd Congress) put an end to that, thereby changing the terms of the contracts without the consents of the bond holders.

We do not believe that the U.S. will ever explicitly default on its debt obligations, even though the previously unthinkable and unspeakable is spoken about a bit more often these days. It is hard to be forced into default when the U.S. enjoys the exorbitant privilege of having a monopoly on the production of the global reserve currency. Phrased differently, it’s easy to stay in business when you can always print more of the currency you need to service debt.

And yet the mere suggestion of default – whether soft or hard – would create enormous volatility in financial markets. Investors would quickly incorporate such risks into interest rates, with concomitant effects throughout the real economy as well. Complacency is the enemy of the investor, and change can happen quickly. In Ernest Hemingway’s “The Sun Also Rises,” a down-on-his-luck character is asked how he managed to wind up bankrupt. “Two ways,” he replies, “gradually, then suddenly.”<sup>5</sup> Markets can remain complacent for a long time and then be quickly shocked into a new reality. There are decades when nothing happens, and there are weeks when decades happen.

<sup>4</sup> Basis point (bp) is a unit that is equal to 1/100th of 1% and is used to denote the change in price or yield of a financial instrument.  
<sup>5</sup> “The Sun Also Rises.” 1926. Ernest Hemingway.





## As inflation is likely part of any economic path forward, investors should protect the purchasing power of their investments.

### What comes next?

Some of these paths forward are clearly more appealing or tolerable than others. We are bullish on the U.S. economy in the long run, and technology-fueled growth is likely to play a role in reducing the (relative) size of debt, but only if the deficit and debt grow more slowly than GDP. Inflation will play a part as well, if for no other reason than that no one votes for it. From a political standpoint, modest inflation is a “free” policy choice with no political price to pay – and one that helps to address the real burden of debt.

But growth alone (whether nominal or real) won’t solve the problem. There are policy choices to be made if we are to correct this course. We’ve seen that cutting federal spending is hard when so much of the federal budget is consumed by various entitlement programs and other mandatory spending. Serious spending cuts would require political will, so we don’t have much hope that tighter belts will be a big part of the solution. Revenues, on the other hand, offer more opportunity, but only if we can find a way to broaden the tax base.

Finally, we reiterate once again that outright default is a remote possibility. Americans’ role in the global economy, and the dollar’s role as the global reserve currency, bestows immeasurable benefits on U.S. businesses and households through lower interest rates and cheaper goods and services. To risk this through default is to risk the bedrock of the U.S. economy.

### Investment implications

It would be a mistake to construct an investment portfolio in anticipation of a single outcome of all the probabilities outlined in this analysis. There are too many moving parts to say with certainty what will happen, or when. As noted, concerns about debt and deficits are a perennial part of the investment landscape, and our successors might very well be writing and reading about these same topics decades hence.

We believe that portfolios are best constructed from the bottom up through individual security analysis and a determination of value. There are, however, some top-down portfolio implications that arise from this analysis.

As inflation is likely part of any economic path forward, investors should protect the purchasing power of their investments. Equities, broadly defined, offer more inflation protection than fixed income, particularly when an underlying company has the brand value, customer loyalty, and pricing power that allows it to raise prices. Furthermore, companies that disproportionately benefit from technology, or create technology solutions for other businesses, are well positioned to participate in and benefit from the productivity engine of future economic growth. Finally, international equities play an important role in well-balanced portfolios as well by broadening the investment selection set and offering exposure to currencies other than the U.S. dollar.

Fixed income continues to play an important role in most portfolios as well, offering a source of regular return, a ballast to the typical volatility of equity prices, and liquidity. But bonds – and government bonds, in particular – warrant close attention and analysis, as some of the solutions to our deficit and debt challenges pose implications for interest rates. Complacency in this asset class is dangerous, and careful and attentive analysis is a way to mitigate the downside risk of policy surprise.

Policy choices could present opportunities as well. If, for example, the government seeks to pursue revenue growth through higher taxes, the tax treatment of securities such as municipal bonds might make them more attractive. We believe that quality always matters in fixed income, and that fundamental analysis is mission critical in identifying this quality.

Nothing went right on June 6, 1944. As allied forces stormed the beaches at Normandy and air-dropped behind enemy lines, the winds blew in the wrong direction, heavy fog made landing difficult, and troops were separated and spread thin. After the war ended, Supreme Allied Commander Dwight Eisenhower was asked how the best military minds got so much wrong. Eisenhower admitted that the D-Day plans turned out to be almost worthless, but he was adamant that the planning won the war. It was, he claimed, the process that mattered most: The planning exercise created the adaptability and flexibility that won the day when circumstances changed in unpredictable ways.

We live in uncertain times. As with military planning, so with investment portfolios. You can’t precisely predict, but you can prepare. ■

*Opinions, forecasts, and discussions about investment strategies represent the author’s views as of the date of this commentary and are subject to change without notice.*

# Independent Return Strategies: Preparing Portfolios for the Future

**Justin Reed**  
Partner  
Chief Investment Officer

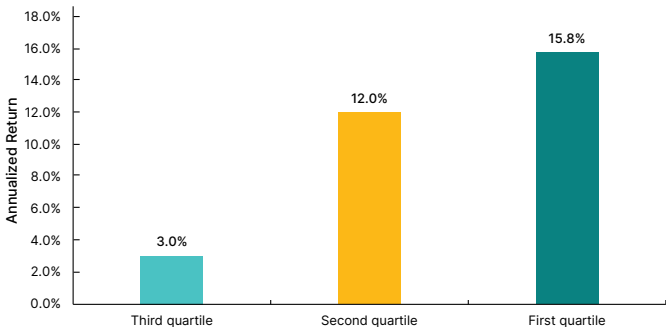
**Ilene Spitzer**  
Managing Director  
Deputy Chief Investment Officer

At BBH, we are always searching for differentiated investment strategies that can help enhance long-term portfolio returns while reducing risk. Over the past few years, we have been particularly focused on adding independent return strategies that can provide equity-like returns but with lower volatility. While we believe this provides unique diversification and return benefits in all environments, independent return strategies can play a particularly valuable role during periods of higher equity market valuations. Here, we explain how incorporating independent return strategies can play a key role in enhancing a portfolio’s return potential, diversifying return sources, and positioning it for the future.

## Market context and portfolio positioning

Despite continuous headlines about volatility and uncertainty, market performance has been strong over the past five years – note the S&P 500’s 16.6% annualized return, which represents a top-quartile return for the index. As shown in the nearby chart, the S&P 500’s first-quartile five-year annualized return between 1988 and second quarter 2025 was 15.8%. Of the 390 rolling observations, the index generated a return greater than 16.6% only 20% of the time.

**S&P 500 annualized five-year returns have been greater than 16.6% only 20% of the time since 1988**

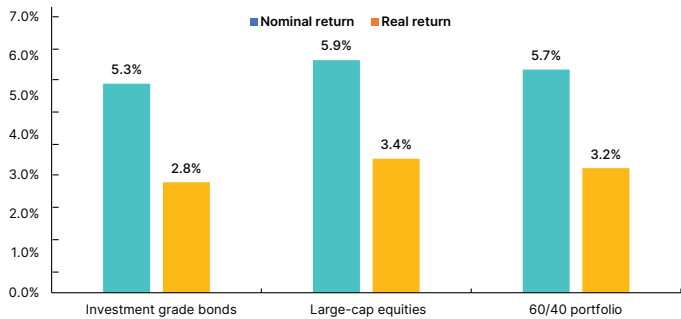


Data as of June 30, 2025.  
Source: FactSet. Based on monthly rolling five-year total return.

Though unpredictability is likely, historical precedent would suggest that the S&P 500’s success of the last five years is unlikely

to continue indefinitely. We must be prepared for this scenario, as using our capital market expectations and based on a variety of analyses, we would be unsurprised to see large-cap equities return mid-to-high single digits annualized over the next 10 to 20 years. We expect inflation to reduce the real return by at least 2% to 3% annualized, implying that holding a simple portfolio of stocks and bonds may not be sufficient for many investors to meet their goals and objectives.

**60/40 portfolio: Estimated low-single-digit real return over next 20 years**



Source: BBH 2025 Capital Market Expectations.  
Capital Market Expectations are hypothetical in nature and do not reflect actual investment results. There is no assurance the returns will be achieved.

To mitigate this possibility, we structure portfolios in the following ways:

- We suggest a public equity portfolio composed of exceptional public equity managers with the ability to generate long-term outperformance across market environments and economic cycles.
- We suggest that those suitable who can access private investments add them to their portfolios, as they can provide the potential for a return premium above public market equivalents.
- We encourage the addition of independent return strategies. These are strategies that can enhance the overall portfolio return profile by generating uncorrelated equity-like returns without being driven by broad equity or credit market conditions while lowering expected portfolio volatility.



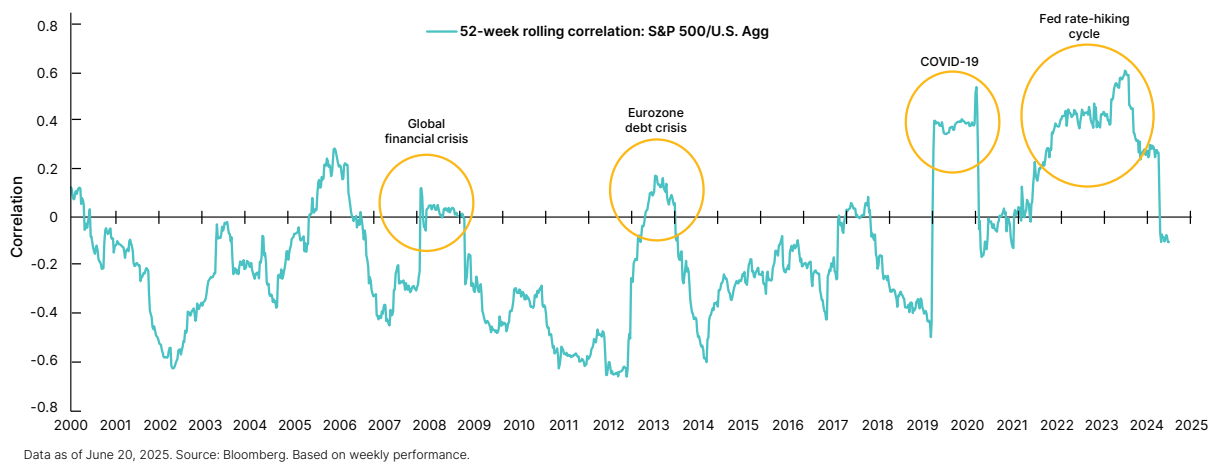


## Why market dependence is a hidden risk in your portfolio

Even traditional portfolios that appear diversified are often more correlated to broad equity market returns than they appear. Despite allocations across asset classes, most investments within a portfolio will rise and fall together in periods of market stress, as correlations tend to increase alongside volatility. As shown in the following chart, we have also seen assets like traditional public equities and fixed income become more correlated over time, for reasons including increased globalization, central bank action, and the rise of high-frequency trading.

“True diversification means adding return streams not tied to market direction.”

### Equities and fixed income correlation typically rises in periods of market turmoil



True diversification means adding return streams not tied to market direction. This is why we have been deliberate in looking for exceptional investment opportunities that can provide attractive returns that are less correlated to market movements. Independent return strategies are such an opportunity.

### What are independent return strategies?

We define independent return strategies as compelling investment opportunities that aim to generate equity-like returns with low beta<sup>1</sup> to public equity markets. With such strategies, we expect investment manager skill (alpha),<sup>2</sup> as opposed to market exposure (beta), to produce the vast majority of performance. Therefore, the return stream does not correlate with systemic risk factors, making it a valuable portfolio diversifier. Independent return strategies are the quiet workhorses of sophisticated portfolios that have the potential to smooth compounding over the long term.

In our view, independent return is not an asset class, but instead falls under one of our second-order capital allocation frameworks: role in the portfolio. Within this, we categorize investments into four different categories, including:

- Long-term inflation protection and growth (public and private equity)
- Deflation protection, income, stability, and liquidity (fixed income)
- Unexpected inflation protection (real assets)
- Independent return (variety of strategies and asset classes)

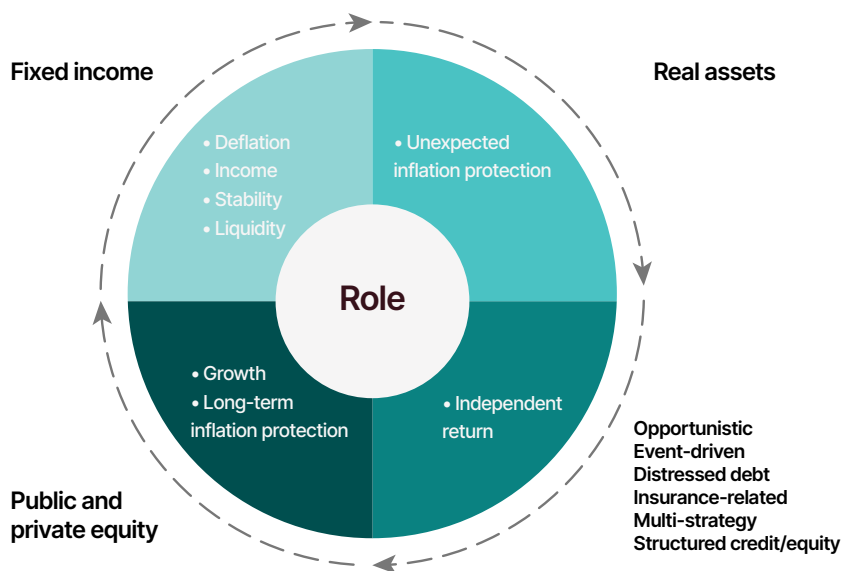
Independent return strategies are not a single type of strategy or product. They can come in a variety of fund structures and liquidity profiles. Such strategies can be accessed via evergreen (i.e., open-ended, non-drawdown) structures or private equity-style drawdown vehicles, for instance.

While these strategies may vary in terms of investment focus and strategy, the successful ones are often skilled at taking advantage of inefficiencies and mispricings to drive returns independently from public equity markets.

<sup>1</sup> Beta is a measure of a portfolio's sensitivity to market movements. The beta of the broader equity market, as measured by the S&P 500, is 1.00 (Source: Morningstar).

<sup>2</sup> Alpha is the amount by which a strategy has outperformed its benchmark, taking into account the strategy's exposure to market risk (Source: Morningstar).





Like independent return strategies, our Investment Research Group (IRG) is structured in a generalist model so that all investment ideas compete for capital, and we can take advantage of these structural inefficiencies to find overlooked, yet exceptional, investment partners.

### What do we look for in independent return strategies?

We take a differentiated approach to building portfolios. The bar for portfolio entry is extraordinarily high, and all investment opportunities compete for capital against other opportunities. As a result, our portfolio is a collection of our best ideas. We invest only in the “best of the best” independent return strategies that we believe will add value to our portfolios and align well with our “10 Ps” framework.

Examples of independent return strategies include:

- Opportunistic
- Event-driven (including distressed debt)
- Insurance-related
- Multi-strategy
- Structured credit/equity
- Royalty-related
- “Tweener” strategies that do not fit easily into definable categories

This last category is worth elaborating. Organizational structures at investment firms often reflect asset class categories, which can result in exceptional investment managers being overlooked because they do not fit neatly into a defined category. For example, investment managers who invest across the capital structure and hold private and public securities as well as equity and credit securities can prove challenging to implement within traditionally structured investment organizations.

Exceptional investment managers who can generate strong returns independent of public equity and fixed income markets are rare, so manager selection is critical to success. In looking for independent return strategies, we focus on finding strategies that will likely benefit from significant and persistent market inefficiencies while providing strong after-fee, after-tax returns.

Investment partners must have explainable processes for exploiting inefficiencies, know what they own and why they own it, and have an ability to assess and appropriately manage risk, among other considerations. Notably, we do not start by looking for portfolio diversifiers. Such an approach can result in the selection of managers that may reduce volatility but also reduce the long-term portfolio return potential. Instead, we focus on strategies that can produce similar or better long-term returns as public equities, but with return streams that look different from public equities.

Independent return strategies	vs.	Traditional strategies
<ul style="list-style-type: none"> <li>• Broad range of investment strategies</li> <li>• Can invest across several asset classes and geographies</li> <li>• Not easily benchmarked over short time periods</li> <li>• Can be liquid or illiquid structures</li> <li>• Equity-like returns profile, lower than equity risk</li> </ul>		<ul style="list-style-type: none"> <li>• Typically invest in stocks and/or bonds</li> <li>• Assess performance against benchmark indices</li> <li>• More narrow mandate</li> <li>• Typically liquid structure</li> <li>• Typically high beta to benchmark</li> </ul>

Our independent return strategies must also generate attractive after-tax results that are comparable with public equity markets. Some categories of these strategies, such as long/short equity or high-turnover strategies, are capable of generating high returns but are often less attractive on an after-tax basis. We tend to avoid these for our taxable clients, though we are always looking for the exceptions.

### What you could gain: Resilience, consistency, flexibility, and returns

Adding independent return strategies is not just about defense; it is also about disciplined offense. The potential benefits of adding such strategies to one's portfolio are myriad.

#### Resilience

Independent return strategies often help provide portfolio-level outperformance during market volatility. Many actually perform best when others are forced to sell, making them powerful during periods of economic crises. Playing offense when others may be playing defense allows for these strategies to often come out well positioned to capture market upside beyond what is available in public equity markets. Coupled with opportunistic repositioning and taking advantage of dislocations, this can allow these strategies to compound in line or ahead of public equity markets over the long term.

We are strong believers in the idea that volatility is not equal to risk. Risk is vulnerability in not meeting one's goals and objectives. Due to their uncorrelated nature, independent return strategies help reduce exposure to systemic risks that can derail long-term goals.

#### Consistency

While we do not consider volatility as a risk, we recognize that volatility can expose and exacerbate vulnerability. Extreme volatility can occasionally lead investors to sell at inopportune times, resulting in impairment of capital. Because of this, we also value what independent return strategies bring to one's overall portfolio from a behavioral perspective. A well-constructed independent return portfolio should not only reduce volatility but also provide a relatively consistent overall portfolio return profile. We have found that this relative consistency reduces behavioral risks, in that those with higher allocations

“

[T]he preservation and growth of capital is about *time* in the markets, rather than *timing* the markets.”

to independent return strategies are more likely to stay invested through market cycles given the reduced correlation to systemic risk factors. As we always highlight, the preservation and growth of capital is about time in the markets, rather than timing the markets.

#### Flexibility

Introducing independent return strategies also facilitates smoother long-term returns that can enhance planning, preserve optionality, and increase flexibility. For example, because those with higher independent return allocations will likely reduce downside volatility, there can be more certainty that allows for improved spending projections.

In moments of market dislocations, independent return strategies can also be a source of portfolio rebalancing and a funding source for outflows and private investment capital calls. This ensures portfolios are not selling public equities to fund liabilities at inopportune times. Such investors will also have more ability to take advantage of opportunities that arise from downturns, exactly when capital becomes more expensive and forward returns more compelling.

#### Returns

Independent return strategies can facilitate stronger compounded returns for a portfolio over the long term, as seen in the nearby chart. A hypothetical \$100 invested into a 60% equity/40% fixed income portfolio in 1988 would have compounded to approximately \$2,600 by June 2025. The addition of a 20% independent return component (60% equity/20% fixed income/20% independent return) would have doubled the traditional portfolio, compounding to approximately \$5,100 over the same time period.

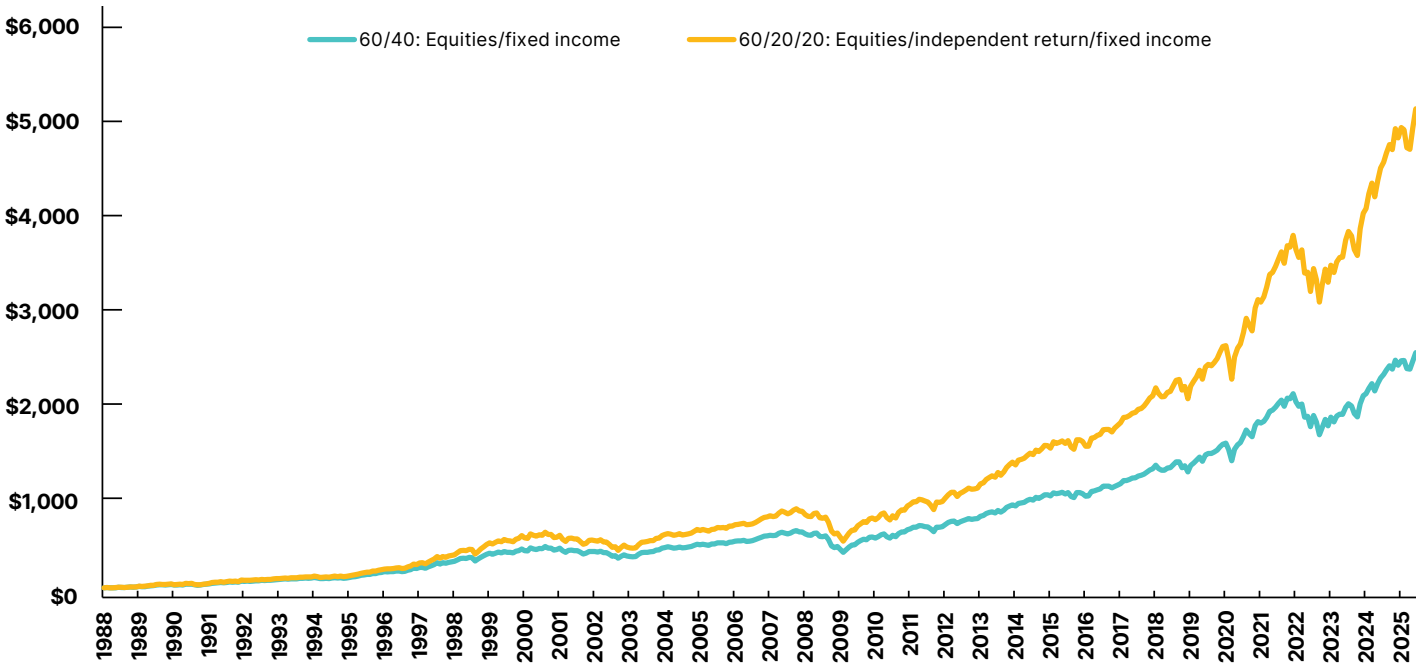


We recently onboarded a new independent return fund that provides a good example of what we look for with such strategies. The evergreen (that is, non-drawdown) strategy invests in securities that are less correlated to broad equity markets, including corporate investment grade and high-yield credit, distressed credit, liquidations, trade claims, restructuring, and structured credit. One way this manager can generate equity-like returns is by performing a deep review of legal contracts for misunderstood assets.

As an example, the team has had success investing in trade claims marked at pennies on the dollar that the market did not recognize were backed by 120 cents of assets. Furthermore, the timing of the payment of the claims is related to legal processes, not by equity market movements.



Hypothetical compounded return in a 60/40 portfolio vs. 60/20/20 portfolio



Equities: S&P 500 Total Return Index  
Fixed Income: Bloomberg US Aggregate Bond Index  
Independent Return: Assumes the hypothetical independent return allocation would realize 40% for the S&P 500's downside when returns are less than 0% (in a down market) and only 80% of the S&P 500's upside when returns are greater than 0% (in an up market).  
All hypothetical returns are rebalanced monthly.

For illustrative purposes only. Index performance is not illustrative of the performance of any BBH investment product. An investment cannot be made directly in any index. Past performance does not guarantee future results.

How to thoughtfully incorporate independent return strategies

Given their meaningful benefits, we believe that independent return strategies should compose approximately 10% to 25% of a portfolio, depending on a client’s goals, risk profile, liquidity needs, and objectives. The higher allocation is more appropriate for those who can access independent return strategies in illiquid drawdown structures as well as their more liquid counterparts. For those individuals, it typically takes commitments over several years to reach the desired long-term targets.

One of the biggest challenges with independent return strategies is that they are difficult to benchmark over short time periods. By definition, their returns should not be highly correlated with traditional benchmarks. This is where our long-term orientation, and our clients’ trust, creates value. Over the long term – which we think of as a full market cycle, or at least five to 10 years – we would expect these strategies to generate returns comparable to, and hopefully in excess of, public equity markets while smoothing the return stream of an overall portfolio.

Like any other investment strategy, independent return strategies must be closely monitored to ensure they are playing their desired role in the portfolio. We watch performance attribution, exposures, stress cases, and factors, among other considerations.

Due to their low equity market correlation, we also closely monitor opportunities to rebalance the overall portfolio, which can facilitate higher long-term portfolio returns.

Conclusion

For years, many investors have viewed equities as the engine driving long-term returns and fixed income as the steering system and brakes that provided control and reduced risk. Our rigorous approach to selecting exceptional independent return strategies allows them the potential to be both the shock absorbers of a portfolio and additional horsepower to drive long-term equity-like returns. This is why we believe that the addition of independent return strategies is not a trend. Instead, it represents the foundation for preserving and growing wealth in an unpredictable world. ■

Past performance does not guarantee future results.

Opinions, forecasts, and discussions about investment strategies are as of the date of this commentary and are subject to change without notice. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be and should not be interpreted as recommendations.

Diversification does not eliminate the risk of experiencing investment losses.

Investment Advisory Products and Services:

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

# Managing Uncertainty in Fixed Income

Tom Brennan  
*Vice President  
Fixed Income Product Specialist*



One reason our clients invest in fixed income is for the stability it can provide. Yet fixed income managers are often faced with decisions affecting this level of stability. How do we at BBH manage fixed income to provide stability while leveraging volatility as an opportunity?

The fixed income markets feel like they have been at the center of many uncertainties this year. Interest rates moved higher since “Liberation Day” on April 2, 2025, despite mounting concerns of an economic slowdown – an environment where interest rates tend to decline. This has happened as tariffs interact with ongoing inflation concerns and U.S. fiscal budgetary deficits. These forces drove Moody’s to downgrade the U.S. government’s credit rating to Aa1, joining the other major rating agencies in assigning the U.S. government’s credit rating one notch below the highest possible level of Aaa.

By any measure, this has been an eventful environment for capital markets. Our goal at BBH is to deliver a performance experience that limits unexpected movements in fixed income portfolios. One way to achieve this objective is to maintain a consistent investment process amid elevated volatility and uncertainty. Here, we shine light on how we approach these decisions in all environments.

## **A bond is a bond, right?**

Several decisions can impact how a fixed income portfolio performs. For example, a portfolio’s positioning regarding duration, yield curve exposures, credit decisions (whether to invest in opportunities that carry default risk), credit quality and repayment risks, and tax considerations all affect a client’s return from fixed income. Performance experiences are determined by how these risks are managed, singly and jointly. Many of these characteristics can be measured quantitatively, while others require subjective, professional judgment.

We believe that some risks can be measured and managed consistently to raise the likelihood of favorable outcomes. Other risks, despite offering the potential for higher return outcomes, are more speculative in realization. Taking a holistic and collaborative approach to understanding our clients’ goals and objectives for their fixed income investments, we separate the process into strategic and investment decisions.



**We seek to optimize performance through combining a valuation discipline with credit criteria aimed at identifying durable investments that can perform through a variety of environments, not just a favorable one."**

### **Strategic decisions: Delivering clients known exposures aligned with their objectives**

Several fixed income risks, such as interest rate duration, are difficult to manage tactically and are best guided by strategic decisions. Our relationship managers partner with clients to understand their overall objectives, risk tolerance, and situational dynamics. This helps us determine the balance to strike among the various roles fixed income can play, including stability, diversification, liquidity, and income. We then manage portfolios by carefully selecting individual credits subject to a duration target and caps on credit allocations.

We believe this generates benefits for both our clients' outcomes and our investors' ability to navigate market dynamics. Our clients can rely on dependably getting the exposures aligned with their strategic objectives rather than worrying if we are on the right side of a trade. Strategic alignment affords our investment team the ability to focus on generating performance consistently from credit selection decisions.

### **Investment decisions: Executing strategic decisions to optimize performance**

Our fixed income team focuses on executing this well-established process. As mentioned, our clients' overall duration, credit quality parameters, and liquidity profile are determined before the team makes any investments. The team then searches the \$50 trillion universe across more than 80,000 potential issues to find those most suitable for our clients' expressed objectives.

In past articles, we spoke about the pillars of the approach we follow. We seek to optimize performance through combining a valuation discipline with credit criteria aimed at identifying durable investments that can perform through a variety of environments, not just a favorable one. We aren't investing in anticipation of a particular macroeconomic condition.

- **Our valuation framework<sup>1</sup> balances the uncertainties inherent in investing with appropriate risk compensation.** The framework provides us with an objective guide to whether an investment's return potential merits further research work from the team. It integrates an investment's known default likelihood, optionality, and liquidity alongside the mean-reversion tendencies of credit spreads, and then requires a margin of safety<sup>2</sup>

for each investment. We believe that incorporating that margin of safety puts the odds of success on our clients' side by providing protection against both credit uncertainties and price volatility.

- **Our research focuses on durable opportunities.** Numerous factors affect our decision-making process during environments of uncertainty. Focusing on durability requires analysts to consider how the investment might perform under a broad range of scenarios, including the worst environment previously faced by its industry. We don't position for those scenarios or potential macro downturns we cannot predict; rather, we aim for portfolios that will ultimately be resilient to any downturn. This allows our team to put a currently volatile environment into a broader context. For example, is the current environment really worse than our modeled worst-case scenario? And do we still believe the company has the business model and adequate strategic options that made it resilient in our modeling?

Other elements of our approach also help us navigate episodes of uncertainty. Our team-based decision-making approach ensures the widest range of perspectives are considered before approving an idea for investment, leveraging the diverse experience of our credit team. Having a team-based approach across the entire fixed income franchise allows us to bring our collective best thinking to client portfolios.

### **Putting it all together: Process over predictions**

We frequently say that volatility is a feature of a market – not a bug. And our fixed income process was designed so that portfolios perform through volatile periods. Amid uncertainty, volatility tends to exceed the underlying fundamental risks, creating investment opportunities. We do not make investments in securities that require a predicted outcome to occur for a successful investment. Instead, we follow our bottom-up approach to ensure that our clients' strategic fixed income goals are met as we adapt to the opportunity set at hand. This way, we can allow process over predictions to drive our client's performance journeys, regardless of the environment. ■

**To learn more about fixed income investing at BBH, reach out to your relationship team.**

<sup>1</sup> Our valuation framework is a purely quantitative screen for bonds that may offer excess return potential, primarily from mean reversion in spreads. When the potential excess return is above a specific hurdle rate, we label them "Buys" (others are "Holds" or "Sells"). These ratings are category names, not recommendations, as the valuation framework includes no credit research, a vital second step.

<sup>2</sup> Margin of safety: when a security meets our investment criteria and is trading at meaningful discount between its market price and our estimate of its intrinsic value.





# Five pieces of advice from a professional trustee to new beneficiaries

**Alison Hutchinson**  
*Principal  
Senior Wealth Planner*

**Melineh Ounanian**  
*Managing Director  
Chief Fiduciary Officer*

Finding out that you are the beneficiary of a trust can be exciting as well as overwhelming and confusing. Questions abound, such as:

- How much can I request from the trust?
- How do I interact with a trustee?
- What does my position as beneficiary mean for my own planning?

Despite the many benefits of trusts, a question we frequently hear, even from the most grateful beneficiaries, is “Why didn’t my family trust me?”

We have counseled beneficiaries who felt guilty about using or even having a trust for their benefit. Perhaps they felt as though they wanted to “make it on their own” and no longer have that opportunity. Many may want to pay it forward to their own children and charitable causes. At the same time, as questions and concerns about the trust are percolating, there may not be many peers who can relate or help answer questions; some may not even want peers to know about the trust because of the negative stigma that can go along with “trust fund babies.” Especially when this is a first experience with a trust, there are sometimes more questions than answers, and trusted advisors who can answer those questions are few and far between.

This article sets forth some ideas for how trust beneficiaries can learn more about their roles and responsibilities. For those thinking about funding trusts, we recommend having some of these conversations with the beneficiaries of your generosity before signing on the dotted line.

## 1. Read the agreement

From the outset, it is important to learn as much about the trust structure as possible. If your trustee doesn't offer one, ask for a copy of the trust agreement. Then, make sure to read it! Organize any questions you have about the trust documents and flow of information and assets. Make sure you are set up for periodic account statements, with the goal to review the information at least annually. You can review the account statement with the assistance of your relationship manager, wealth planner, trustee, or any other trusted advisor. Familiarize yourself with the time horizon and tax implications of the trust, both income and transfer tax, which will have a direct impact on the asset allocation and investments in the trust account. It is also important to understand how taxes factor into the ordering of this account as an available source of funds and how a distribution may impact your personal income tax situation. You aren't expected to know all of these things at the outset, which brings us to No. 2 ...

## 2. Ask questions

As a beneficiary, there are no questions that are too big or small. You should reach out to your trustee to understand the trust, both as a legal document and to measure the real life impact it may have on your family. Trusts have different types of beneficiaries, often distinguishing between beneficiaries who can get trust income vs. trust principal, get distributions now vs. after some future event, and even "primary" beneficiaries. (Those poor nonprimary beneficiaries! If you are one, we can explain, and it's probably not personal.) There may be language giving the trustee the discretion to distribute "so much or all" of the trust to the beneficiaries for any purpose in the trustee's discretion. That is not a blank check, however, so even with this seemingly vague language, there are limits to how much is prudent for a trustee to distribute.

There will always be competing interests between current and future beneficiaries, which is especially true for dynastic or perpetual trusts designed to last several generations. Although most trust agreements do not require equal distributions among beneficiaries, there is a fundamental duty of impartiality, which means the trustee must consider what is equitable when making decisions. As you might expect, this can create tension between a trustee trying to do her job and a beneficiary who would like access to funds. Asking questions early on can help set expectations and build trust (no pun intended) and will open very important lines of communication between you and your trustee.

## 3. Learn the process

How do you request distributions, and what documentation might you be required to provide? Depending on what the trust or letters in the trust file from the person who funded the trust explaining their intent say, you may be asked to provide a budget or copy of a recent tax return in connection with a request. While this can feel intrusive, the trustee has a duty to administer the trust in accordance with its terms and in a way that promotes transparency and fairness among all beneficiaries. Rest assured, the details of your request are not shared with other beneficiaries.

You should also consider what the terms of the trust say about how and when distributions should be made. How will distribution requests be considered if a trust agreement provides for distributions for "health, education, maintenance, and support"? Can you simply submit medical bills and expect reimbursement? How much education is "too much" education, if any? What in the world do "maintenance and support" mean? Knowing how your trustee interprets the trust agreement on these important points will again help guide you in requesting a distribution, submitting an invoice, or funding certain expenses from your own non-trust accounts.

## 4. Communicate

You may by now be sensing a theme: Communication is key. Knowing the role your trust plays in your overall plan can be a key component of long-term financial health and a good trustee/beneficiary dynamic. The options for a trust may seem like a choice between depletion for your current needs and safeguarding to preserve for future generations. However, another perspective is to envision how the trust can help you reach your personal financial goals and to help you establish your own independent source of support and stability.

Share your financial plans and goals with your trustee early in the process, especially if you would like to determine whether the trust can be used to help pay for your first home, further education, or fund a new business venture. In certain circumstances, it may be better from a tax or creditor perspective to leave assets in the trust and draw on more traditional commercial funding. In those cases, a trustee's confirmation of available trust assets, rather than an outright distribution, may be the best course of action.

Consider the trust in terms of your own estate plan as well. Many trusts provide powers of appointment, giving you the ability to determine to whom funds will flow at a certain point, usually at death. Knowing whether you can or should reference this trust in your own will is important to understand before you write one.

## 5. Call on your team

The best way to promote a good experience with this seemingly odd legal structure is to remain curious and involved. Establishing an open discourse with the trustee and other members of the team will make the process easier.

At BBH, we can help bring clarity and context to the trust, explain the nuances of administration, and provide stories of when (and why and how) similarly situated beneficiaries had excellent experiences, or challenging ones. We also have tools to help you start these conversations with your family and make the most of this valuable role. To think about how to get started, contact a BBH trust officer, wealth planner, or relationship manager. ■



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