

ALERT**MARCH 17, 2011**

How Exposed is Your Portfolio to Japan?

Since March 11, Japan has suffered a horrific set of disasters, including earthquakes, a tsunami and multiple nuclear reactor failures. The total loss of human life, property damage and the impact to Japan's economy is still being calculated. In fact, the full scope of this tragedy won't be clear for some time. As disturbing as the events in Japan are, we would like to share our initial thoughts on how exposed our clients' investment portfolios are to Japan, its economic impact and what actions investors should take now:

Exposure

The Japanese stock market accounts for about 22% of the MSCI EAFE international stock index. The international and global mutual funds that we employ in our many of our clients' portfolios report exposures to Japanese equities as low as 2% and no greater than 14% (and please keep in mind that only a portion of any client's equity portfolio is invested in global and/or international funds). So on this basis, our clients' portfolios are not significantly exposed to Japan.

Even so, the above numbers may not precisely reflect any given fund's exposure as fund holdings can change since the end of the prior reporting period. Most of the mutual funds that we employ are considered actively managed – that is to say that the fund managers actively select investments for their portfolios. With the resulting declines in the Japanese stock market over the last week it is likely that some managers have increased (or decreased) their Japan exposure.

And just because a company is domiciled in Japan, doesn't mean that it is significantly exposed to Japan. Many Japanese companies are multinational companies (i.e. Toyota, Honda, Canon, Sony, etc.), that derive much of their revenue from non-Japanese sources. Thus an economic

slowdown in their home country may not significantly impact these companies so long as they can continue to produce and ship product.



Conversely, just because a company is domiciled outside Japan doesn't mean that it avoids being impacted Japanese events. For example, the insurer Aflac, Inc. writes 75% of its sales in Japan. Coach and Tiffany generate about 20% of their revenues in Japan. Other companies in the S&P 500 Index that obtain 10% or more of their sales from Japan include Freeport-McMoRan Copper & Gold, Hartford Financial Services Group, Adobe Systems, Corning Inc, Waters Corp, Qualcomm Inc. and Boston Scientific Corp.

Economic Impact

Barclay's Capital has estimated that the damage from the earthquake and tsunami will cost Japan about \$185 billion, or less than 5% of the country's 2011 GDP. For some context, Hurricane Katrina cost the U.S. about \$100 billion in today's dollars and the 1995 Kobe earthquake cost Japan about \$120 billion. The estimates for this event are rough approximations, as the full extent of the unfolding nuclear disaster are not yet known. If the nuclear disaster becomes more serious, the cost estimate could escalate significantly.

The initial hit to the Japanese economy will certainly be felt as the quake and tsunami damaged area accounts for about 6% to 7% of the Japanese economy. Damages to ports and other infrastructure, interruptions in power generation and distribution systems will impact other areas of Japan too. In addition, the economic impact will be felt outside Japan as many manufacturers in the rest of the world rely upon parts and materials shipped from the affected area.

On a more positive note, the Japanese will rebuild. The massive rebuilding effort will significantly add to future Japanese and global GDP. Rebuilding will create jobs, spur economic activity around the world and take years to complete – making the positive economic impact longer lasting.

What actions should investors take now?

The events in Japan already have impacted the currency, fixed-income, equity and energy markets. The Japanese stock market has dropped about 20% since the earthquake struck. This is reminiscent of 1995, when the Japanese market fell by over 20% in the week following that earthquake – the market then recovered its losses within the next two weeks. This time around, the Japanese market may take much longer to recover. However, it's likely too late for most investors to insulate their portfolios from the downside impact of this disaster.

This reminds us of a major lesson re-learned by investors during the 2008-2009 financial crisis. The investors who were negatively impacted most, were those who succumbed to the tsunami of negative news and decided to liquidate their investment portfolio in an effort to "save what they had left." They turned paper losses into real losses. And we have witnessed first hand how this emotional response has negatively impacted many of them. The action they took to protect themselves unfortunately diminished their pool of financial resources resulting in their now having to make adjustments to their planned lifestyle. Had they been disciplined in sticking to their investment plans and staying the course, their portfolios would have recovered remarkably quickly. While we didn't know this at the time (only in hindsight do we know how quickly things recover) our counsel was always to stay the course.

At Madison, we proactively mitigate potential negative impacts on our clients' portfolios by focusing on the right asset allocation for each client and by minimizing their exposure to any single country or company. This is true of our exposure to Japan. And it will remain true of our exposure to the next natural or man-made disaster. Even so, we are not fully able to mitigate the downside impact of falling equity or bond prices, as globally diversified portfolios can only do so much. This said, we are confident that our clients' investment portfolios will weather this storm and the next, just as they did the last market crisis.

Please contact our Portfolio Management Team at (888) 943-4198 if you'd like to discuss your portfolio and its risk exposure in more specific terms.