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For the Intelligent Investor
Answers to questions you may not even know you have.

Defusing the Inflation Time Bomb

This essay was originally published in Muhlenkamp Memorandum *Issue 10, July 1989, in response to questions about "The Inflation Time Bomb." It discusses alternatives an investor faces in trying to maintain purchasing power. (2007 numbers are in parentheses, where appropriate.)*

The intent of "The Inflation Time Bomb" was to point out that long-term investment planning that focuses only on dollars and income, while ignoring purchasing power and assets, can be a trap. Dollars must be adjusted for inflation to get purchasing power, and incomes must be adjusted for the loss of purchasing power. Without these adjustments, assets will be depleted and so will income.

The problems that arise from neglecting to make these adjustments have come to the fore over the last 30 years as inflation created large differences between nominal and real interest rates. They have been exacerbated by the fact that many people now seek to retire and live off the income produced by their assets for 20 or 30 years. If you are planning this same sort of "live off the income" strategy, we cannot emphasize the following point enough: only those returns in excess of inflation can be spent if purchasing power is to be maintained over long periods of time.

Given the task of maintaining purchasing power vs. inflation, an investor faces three natural investment markets: short-term debt, long-term debt, and equities.

Short-Term Debt

From the borrower's perspective, short-term debt finances such items as installment and credit card purchases, corporate inventories, and government working capital. From the saver's perspective, short-term debt includes passbook savings accounts, Treasury bills, certificates of deposit, commercial paper, and money market funds. Anyone who has a 9% (4½% in 2007) CD, for example, and is paying 18% on a credit card balance is participating on both sides of the short-term debt market, and paying dearly for the privilege.

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Historically, rates available to savers on these investments have roughly equaled inflation. That is, with no effort and little risk you've made no real money—*after* inflation. Only since 1981 have these rates consistently exceeded inflation, after being well below inflation during the 1970s. Because returns in the short-term debt markets cannot be expected to beat inflation for long periods of time, there is no reason to believe the current, 1989, premium over inflation will endure.

Long-Term Debt

From a borrower's perspective, long-term debt finances factories, homes, and government spending. From an investor's perspective, long-term debt takes the form of corporate bonds, Fannie Mae and Ginnie Mae mortgage pools, and Treasury and municipal bonds. Differences in interest rates among these securities reflect creditworthiness, time-to-maturity, and taxation (municipals).

Historically, long-term debt of good quality has returned about 2%–3% annually over inflation. In the 1970s, it returned substantially less; in the 1980s, substantially more. (For a look at these same numbers from a borrower's perspective, see our "Wake Up, America—Houses Don't Make You Money!" essay.) There is no reason, however, to expect to earn more than 3% over inflation for very long. Therefore, if you own long-term bonds and want to maintain purchasing power, spend only about 3% of your assets per year. If you think inflation and interest rates will decline and want to lock in current rates, be sure the bonds you buy are noncallable.

Equity

Equity investments represent ownership and are normally long term. Equity ownership can be real estate, tangible assets, or business enterprise. It can be sole ownership, partnership, or shares in a corporation. Most investors hold real estate through sole ownership of their homes, and corporate enterprise through shares of stock. Corporate shares are usually more liquid than real estate—that is, they can be bought and sold much more readily. This advantage is partly offset by the short-term volatility of share prices.

The key is to focus on the long-term nature of equity investing and not get caught up in short-term price oscillations. Long-term studies of total returns from owning common stocks of corporations demonstrate returns of 5%–7% annually over inflation. Some of this return comes as dividends and some as capital gains. No one disputes that returns from equity investments are higher than those from debt. However, there are a lot of misleading opinions as to why they are higher.

Corporate stocks provide higher returns than corporate bonds because management works for the stockholder and against the bondholder. No management will borrow money (issue bonds) unless it expects to profit from the investment of those funds in its business. Thus, the return on stockholders' equity must be higher than corporate interest rates. Otherwise, management will cease to borrow, driving interest rates down. (In 1981 and 1982, when long-term interest rates exceeded the average corporate return on shareholder equity, the above observation convinced us that interest rates had to fall.)

Similarly, every corporate treasurer has the same incentive that you and I have: to save money. They call high-rate bonds and reissue low-rate bonds; we refinance our high-rate mortgages. Looking at it from the lender's perspective, that's why most of the bonds we buy are noncallable. We want to avoid having our high-return investment rolled into one with a lower return.

Wall Street types say stocks provide higher returns than bonds because they are "riskier." But Wall Street's definition of risk is volatility— that is, how much prices fluctuate on a daily, weekly, or monthly basis. We believe most people's definition of risk is the probability of losing money. These are fundamentally different views.

In 1987, stock market volatility was very high—both up and down. No one complained about the volatility up, only the volatility down. The total return for the 12 months was roughly zero. Any businessman will tell you that to have a disaster and break even for the year isn't bad. The key is to view equity investments as long-term business investments, with a horizon of at least three years. This means that if your planned use for the funds invested is next year's vacation, or college tuition two years from now, don't buy long-term stocks or bonds. But if you'll need the funds for retirement 10, 15, or 20 years down the road, don't worry about price oscillations.

Editor's Note

Notice that even though in 1989 short-term rates exceeded inflation, Ron did not expect it to last. And it didn't. He didn't have a crystal ball. He simply looked at the historical data, understood it, and applied it. Historically, interest rates on short-term debt equal inflation, interest rates on long-term debt are 2%–3% over inflation, and common stocks return 5%–7% over inflation. So for the long-term investor (over three years), stocks normally perform better than bonds.

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