MuhlenkampMethods
For the Intelligent Investor
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Let's Get Real: Understanding Your Purchasing Power

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In anticipation of higher interest rates, we begin to think about inflation and the impact on our money. We know inflation can increase the price of a house or a car. As consumers and investors, we need to think of inflation *not* in terms of prices moving higher, but as the value of our money shrinking—our loss of purchasing power!

At Muhlenkamp and Company, when we initially work with a client, we review their savings and spending—and we listen to what they want their money to do for them. Most often, their primary objective is to make their money work as hard for them as they have worked for it. When talking about investing for the long term, we discuss taxes, interest rates, and inflation. What is the impact? In order to do this, we have to get ***real***. In terms of the client's financial situation, where are they now and where do they want to be?

One of the first steps in this process is to understand the difference between a nominal interest rate and a real interest rate:

- A nominal interest rate is the rate of interest on an investment prior to taking any adjustment for inflation. The nominal interest rate is the interest rate stated on the loan or yield on an investment.
- The real interest rate is the nominal rate, minus inflation. It reflects your true purchasing power!

Here's an example:

If you are earning 3% per year on a CD (certificate of deposit) and inflation is currently at 2%, then the real interest rate you are receiving is 1%. The real value of your savings is increasing by 1% per year when purchasing power is taken into consideration.

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

1. **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 savings accounts, Treasury bills, CDs, and money market funds. Anyone who has a 3% 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.

   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.

2. **Long-term debt:** From a borrower's perspective, long-term debt finances homes, factories, and government spending. From an investor's perspective, long-term debt takes the form of corporate bonds, 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. Currently, it's substantially less.

3. **Equities:** 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, partnerships, or shares of stock 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 to get caught up in the short-term price fluctuations. 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.

You want your money to work as hard for you as you have for it. To do so, it is essential to understand what your ***real*** interest rate is yielding on your investments. You need to know if your assets are gaining in value and, ultimately, increasing your purchasing power.

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One of Muhlenkamp & Company's maxims is "Only those returns in excess of inflation can be spent if purchasing power is to be maintained over long periods of time." In today's investment climate, we believe this can best be achieved through viewing equity investments as long-term investments, with a horizon of at least 3-5 years.

The comments made in this commentary are opinions and are not intended to be investment advice or a forecast of future returns.

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