Chapter 2:
The Investor and Inflation

Inflation in History

we have had inflation in the past—lots of it. The largest five-year dose was between 1915 and 1920, when the cost of living nearly doubled. This compares with the advance of 15% between 1965 and 1970. In between, we have had three periods of declining prices and then six of advances at varying rates, some rather small. On this showing, the investor should clearly allow for the probability of continuing or recurrent inflation to come. Can we tell what the rate of inflation is likely to be? No clear answer is suggested by our table; it shows variations of all sorts. There is no close time connection between inflationary (or deflationary) conditions and the movement of common-stock earnings and prices.

TABLE 2-1 The General Price Level, Stock Earnings, and Stock Prices at Five-Year Intervals, 1915–1970

	Price Level[a]		*S & P 500-Stock Index*[b]		*Percent Change from Previous Level*			
Year	Wholesale	Consumer	Earnings	Price	Wholesale Prices	Consumer Prices	Stock Earnings	Stock Prices
1915	38.0	35.4		8.31				
1920	84.5	69.8		7.98	+96.0%	+96.8%		− 4.0%
1925	56.6	61.1	1.24	11.15	−33.4	−12.4		+ 41.5
1930	47.3	58.2	.97	21.63	−16.5	− 4.7	− 21.9%	+ 88.0
1935	43.8	47.8	.76	15.47	− 7.4	−18.0	− 21.6	− 26.0
1940	43.0	48.8	1.05	11.02	− 0.2	+ 2.1	+ 38.1	− 28.8
1946[c]	66.1	68.0	1.06	17.08	+53.7	+40.0	+ 1.0	+ 55.0
1950	86.8	83.8	2.84	18.40	+31.5	+23.1	+168.0	+ 21.4
1955	97.2	93.3	3.62	40.49	+ 6.2	+11.4	+ 27.4	+121.0
1960	100.7	103.1	3.27	55.85	+ 9.2	+10.5	− 9.7	+ 38.0
1965	102.5	109.9	5.19	88.17	+ 1.8	+ 6.6	+ 58.8	+ 57.0
1970	117.5	134.0	5.36	92.15	+14.6	+21.9	+ 3.3	+ 4.4

Inflation and Investment

On the basis of these undeniable facts many financial authorities have concluded that (1) bonds are an inherently undesirable form of investment, and (2) consequently, common stocks are by their very nature more desirable investments than bonds.

Common stocks may do better in the future than in the past, but they are far from certain to do so.

Inflation and Corporate Earnings

1. Another and highly important approach to the subject is by a study of the earnings rate on capital shown by American business. This has fluctuated, of course, with the general rate of economic activity, but it has shown no general tendency to advance with wholesale prices or the cost of living.
2. our calculations make no allowance for an increase in common-stock earnings and values to result from our projected 3% annual inflation. Our justification is the absence of any sign that the inflation of a comparable amount in the past has had any direct effect on reported per-share earnings. The cold figures demonstrate that all the large gain in the earnings of the DJIA unit in the past 20 years was due to a proportionately large growth of invested capital coming from reinvested profits.
3. Our figures in Table 2-2 indicate that so far from inflation having benefited our corporations and their shareholders, its effect has been quite the opposite. The most striking figures in our table are those for the growth of corporate debt between 1950 and 1969.
4. Clearly there have been important offsetting influences which have prevented any increase in the real profitability of American corporations as a whole. Perhaps the most important of these have been (1) a rise in wage rates exceeding the gains in productivity, and (2) the need for huge amounts of new capital, thus holding down the ratio of sales to capital employed.

Inflation and Corporate Earnings – cont.

5. The stock market has considered that the public-utility enterprises have been a chief victim of inflation, being caught between a great advance in the cost of borrowed money and the difficulty of raising the rates charged under the regulatory process.

6. All of the above brings us back to our conclusion that the investor has no sound basis for expecting more than an average overall return of, say, 8% on a portfolio of DJIA-type common stocks purchased at the late 1971 price level.

TABLE 2-2 Corporate Debt, Profits, and Earnings on Capital, 1950–1969

		Corporate Profits		*Percent Earned on Capital*	
Year	*Net Corporate Debt (billions)*	Before Income Tax (millions)	After Tax (millions)	S & P Data[a]	Other Data[b]
1950	$140.2	$42.6	$17 8	18.3%	15.0%
1955	212.1	48.6	27.0	18.3	12.9
1960	302.8	49.7	26.7	10.4	9.1
1965	453.3	77.8	46.5	10.8	11.8
1969	692.9	91.2	48.5	11.8	11.3

Alternatives to Common Stocks as Inflation Hedges

1. The standard policy of people all over the world who mistrust their currency has been to buy and hold gold. But during all this time the holder of gold has received no income return on his capital, and instead has incurred some annual expense for storage. Obviously, he would have done much better with his money at interest in a savings bank, in spite of the rise in the general price level.
2. Protect himself against inflation by putting his money in “things.” Quite a few categories of valuable objects have had striking advances in market value over the years—such as diamonds, paintings by masters, first editions of books, rare stamps and coins, etc. Very few of our readers will find the swimming safe and easy there.
3. The outright ownership of real estate has long been considered as a sound long-term investment, carrying with it a goodly amount of protection against inflation. Unfortunately, real-estate values are also subject to wide fluctuations. Finally, diversification is not practical for the investor of moderate means, except by various types of participations with others and with the special hazards that attach to new flotations—not too different from common-stock ownership

Conclusion

Naturally, we return to the policy recommended in our previous chapter. Just because of the uncertainties of the future the investor cannot afford to put all his funds into one basket—neither in the bond basket, despite the unprecedentedly high returns that bonds have recently offered; nor in the stock basket, despite the prospect of continuing inflation.

The more the investor depends on his portfolio and the income therefrom, the more necessary it is for him to guard against the unexpected and the disconcerting in this part of his life.

It is axiomatic that the conservative investor should seek to minimize his risks.