

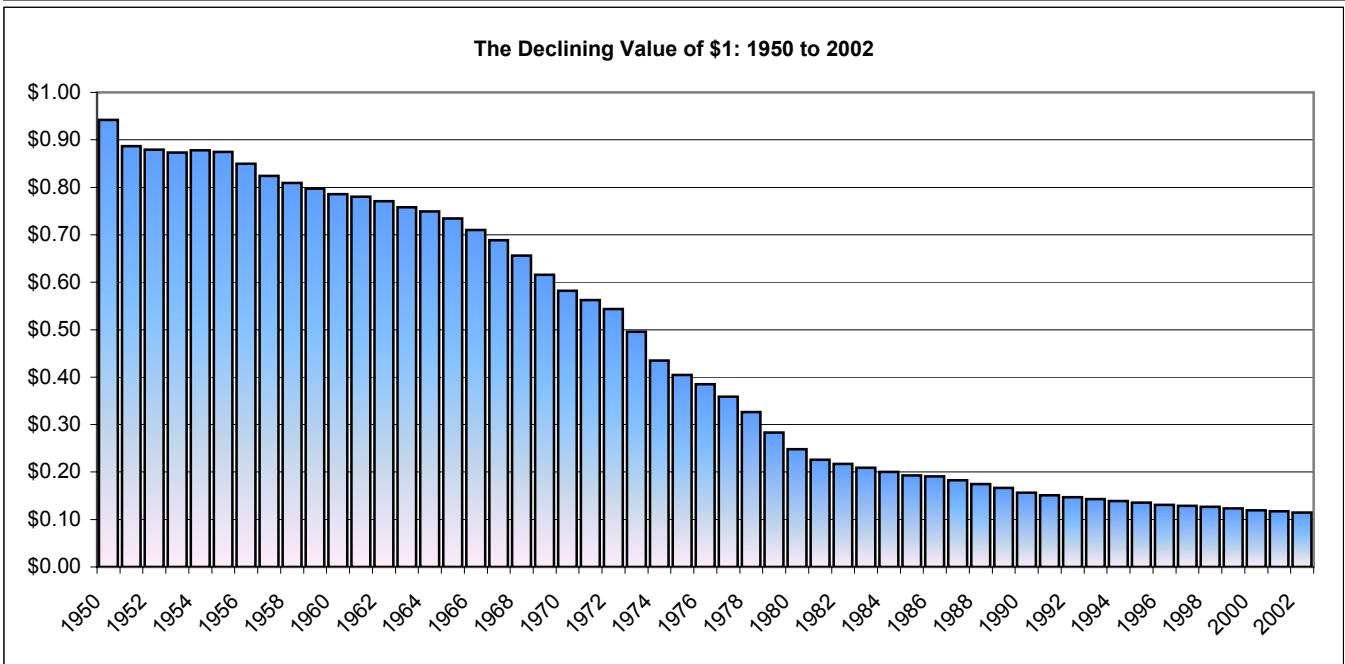
The perils of inflation

"Inflation is not all bad. After all, it has allowed every American to live in a more expensive neighborhood without moving."

Alan Cranston, 1914-2000, former U.S. senator

In our last commentary we wrote that, "Inflation is much more detrimental to the long-term prosperity of people than is recession." The reason is that recessions come and go, but inflation is constantly eroding the purchasing power of our money (chart above).

Recently Federal Reserve Chairman Alan Greenspan voiced his concern about the prospects for deflation, but only once since World War II has the U.S. economy experienced generally falling prices. Since 1950 inflation has averaged just 2.7% per year but it has eroded the value of \$1 to just 11 cents, an 89% reduction (chart below).



People think of inflation as prices going up. It's really not. It's the value of money going down.

For someone who is looking to retire and live off their assets for the next 20 years, the detrimental effect of inflation ought to be one of their greatest concerns. Even at low levels of inflation, the effect is insidious. At an inflation rate of 2% for 20 years, the decline in purchasing power is about one third. At a 3% inflation rate for 20 years the purchasing power reduction is nearly one half.

Conventional wisdom says that one should, "Spend only the income and don't touch the principal." This 'rule' was designed to protect assets and avoid profligacy. The problem is that it's important to think in terms of purchasing power, not in terms of principal and income. For example, if inflation is 3% then the principal has to grow by 3% per year merely to offset inflation. Only the additional income above the inflation rate should be spent so as not to reduce future purchasing power.

Given the challenge of maintaining purchasing power versus inflation, an investor faces three investment choices: short-term debt (cash), long-term debt (bonds) and equity (real estate and stocks).

Short-Term Debt: This asset class includes money market funds, passbook savings accounts, treasury bills, certificates of deposit and commercial paper. Anyone who has a 3% CD and is paying 15% on a credit card balance is participating in both sides of the short-term debt market (and paying dearly for the privilege). Historically, returns on short-term debt instruments have roughly equaled inflation. Thus, these are generally not good long-term investments to own to protect against the ravages of inflation.

Long-Term Debt: From a borrower's perspective, long-term debt finances factories, home and government spending. From an investor's perspective, long-term debt takes the form of corporate bonds, mortgage-backed bonds, treasury and municipal bonds. Differences in interest rates among these securities reflect credit worthiness, time-to-maturity, and taxation (municipals). Historically, long-term debt of good quality has returned about 2 to 3% annually above inflation, but not every year. Therefore, if you own long term bonds and want to maintain purchasing power, count on spending only about 2 to 3% of your assets per year.

Equity: Equity investments represent ownership. Ownership can be real estate, tangible assets or a 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. Over the long-term common stocks of corporations have generated annual returns of 5 to 7% above inflation.

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. One reason people feel good about their homes as investments is because they price them only once every 5 or 10 years. Stock prices, on the other hand, are priced every minute of the weekday. The volatility in stock prices causes many people to lose sight of the long-term benefits of stock ownership by surrendering to their fears and selling just as the market plunges to short-term lows. The key is to focus on the long-term nature of equity investing, and not get caught up in short-term price oscillations.

In recent years, many investors have begun to question whether stocks will outperform bonds. While this is a natural question after a three-year bear market, historically corporate stocks have provided higher returns than corporate bonds perhaps because management works FOR the shareholder 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 shareholder's equity over time must be higher than corporate interest rates.

In the end, an investor's choices for defusing the inflationary time bomb are:

Short-Term Debt: Don't expect returns above the inflation rate for extended periods of time.

Long-Term Debt: Expect returns of 2 or 3% over inflation, but not every year. Use a 5 to 7 year time horizon.

Equity: Expect returns of 5 to 7% over inflation, but again not every year. Use a 5 to 10 year time horizon.

To protect against inflation, select the mix of debt and equity investments that is right for you and diversify among those investments. Then don't let anything (including market fluctuations) throw you off course.

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