



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 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 credit worthiness, time-to-maturity and taxation (municipals). Historically, long-term debt of good quality has returned about 2-3% annually over inflation. In the 1970's it returned substantially less. In the 1980's, substantially more. (For a look at these same numbers from a borrowers perspective, see "Houses Don't Make Money.") 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, count on spending only about 3% of your assets per year. If you think inflation and interest rates will decline and want to "lock in current rates, make sure the bonds you buy are non-callable.

### **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, i.e. 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 4-6% 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 is a lot of misleading opinion 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 stockholder's 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 to call high rate bonds and reissue low rate bonds that you and I have to refinance our high rate mortgages: it saves money. 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, i.e. 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 twelve 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 2 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.

One reason people feel good about their homes as investments is because they price them only once every 5 or 10 YEARS. Some of these same people will call their stockbroker for quotes every few HOURS. They would do better in the long run to price their portfolios as infrequently as their personal residences.

In the end, your choices for defusing the inflationary time bomb are:

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

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

Equity: Expect returns of 4 to 6 percent over inflation, but again not every year. Use a 3 to 5 year horizon.

In all cases, buy value and don't buy junk. If you don't know how to differentiate between value and junk, accept bank CD rates and make no money (after inflation). Or hire someone who CAN differentiate and whose investment approach makes sense to you.