Examining The Long-Term Record

Equities vs Fixed-Income

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The Investor's Edge article "Finding the Hidden Risks" defined the risk of loss of purchasing power (the inflation risk) as "… the possibility that money will have less real value as time passes…" We pointed out that "… in order to preserve the purchasing power of our dollars, the rates of return on our investments must exceed the inflation rate. Indeed, if we are to receive any 'rent' for our money our rate of return must exceed the inflation rate by the amount of rent that we desire." Several recent studies have put the inflation adjusted growth of equities, fixed income securities (including treasury bills) and gold into proper perspective. We think the findings of these studies are significant to all investors; excerpts from them are attached to this article.

The Institute for Econometric Research Study

The Institute for Econometric Research, in its report on long-term investment return details the inflation adjusted growth from 1871 through 1993 (123 years) of common stocks, U.S. Treasury Bills and gold. This long period includes World War I, the 1929 Crash, the depression years, World War II, the pervasive 1969 to 1974 bear market, and the crash of 1987. The results of this study are astonishing: over this 123 year period common stocks, *adjusted for inflation*, increase in value 17,915 times or a compound rate of growth of 8.3% per annum. U.S. Treasury Bills, however, increased at 1.8% per annum compounded or about 1/5 of the annual *real* return accorded common stocks. Gold, despite the dramatic rise from $42 per ounce in 1971 recorded a negative return as $1 invested in 1871 is worth 86¢ 123 years later. The conclusion of the study is obvious: only common stocks have provided meaningful *real* returns for the long-term investor.

The Ibbotson Associates Study

The results of the second study are the same, although the period of time is shorter and the numbers are, therefore, slightly different. Ibbotson Associates, Inc., a Chicago research/consulting organization, annually updates its study "Stocks, Bonds, Bills, and Inflation", which measures the 70 year period from 1925 to 1995 and therefore includes the 1929 crash, the depression years, World War II, the 1969-1974 bear market and the 1987 crash. The results for equities are almost identical to the Institute study, showing an inflation adjusted growth in large common stocks of 7.2% and in small common stocks of 9.1% per annum compounded. However, U.S. Treasury Bills show a much lower inflation adjusted compound of .6% over this period. This study did not include gold but did include long-term corporate and government bonds which grew at 2.0% (governments) to 2.5% (corporates) per annum after adjustment for inflation.

The Bottom Line

So, the "bottom line" conclusion is that U.S. Treasury Bills provide safety, but only nominal protection against loss of purchasing power. Over time equities will likely result not only in actual gains but gains that exceed the rate of inflation and, therefore, provide *real* growth.