

Eads & Heald Investment Counsel

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Equity Investing

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Chapter 9: Growth in Wealth: Stocks, Bonds, T-Bills and Inflation

It is useful to be aware of how key financial assets have appreciated and built wealth over the years. This can instill confidence for difficult times as well as assist you in constructing a portfolio that is appropriate for a particular stage of your life.

Herein, stocks are the Standard & Poor's 500 index of stocks, bonds are high quality corporate bonds with 20 years to maturity and treasury bills are simply 90 day Treasury bills. The comparative inflation is the U.S. Consumer Price Index.

We use a semi-log graph so we can easily spot any constant rates of growth in wealth accumulation. Stock and bond returns are total returns. That is, stock returns include price appreciation along with dividend yield. Bonds include price changes as well as interest paid. Treasury bills are issued at a discount off of par and the appreciation to par over 90 days is the rate of return.

Examine Chart 1. All four entities are started at the end of year 1900 with one unit of value. Think of it as \$1. The original \$1 in stocks becomes \$13,116.0 over the 108 years. This is a return of 9.2% per year. For bonds the \$1 becomes \$381.7 for a return of 5.7% per year. Another way to view the numbers is to think of starting with \$10,000 at the end of 1900 becoming \$131.1 million for stocks or \$3.8 million for bonds where taxes are ignored in both cases. This is a big difference! Of course, 108 years is a long life of exercising, no smoking and eating right.

The 90 day treasury bills go from \$1 to \$61.3 for a 3.9% per year return. \$10,000 would grow to \$613,000 over the 108 years. Risk and return go hand in hand. The investment with the greatest risk, or volatility, makes the most money over the long haul. However, the higher returns result in more uncertainty and anguish along the way. Plus, inflation moves along over the 108 years at a rate of 3.2% per year. This removes a lot of the purchasing power of the various returns. The real return (above inflation) for stocks is 6.0% per year, for bonds it is 2.5% per year and for T-bills it is only 0.7% per year return above the ravages of inflation. Inflation cannot be ignored in any plan to accumulate wealth and purchasing power.

Look at Chart 2. This shows the year-by-year returns for each of the three investment vehicles from Chart 1. Far and away, stocks have the most upside/downside volatility (sleepless nights) over the years. The treasury bills have the lowest year-by-year volatility.

Notice in Chart 1 how bond returns (wealth accumulation) begin to pick up around the year 1980. Now, notice in Chart 2 how the annual up/down volatility of bond returns also starts to increase in 1980.

Accept the axiom that risk (volatility) of returns goes hand-in-hand with higher long-term returns. There is no free and easy lunch. But, this makes sense. How could it work in any other way? Stocks are not a crapshoot or rigged casino. Stocks behave in a very orderly fashion. Stocks are disparaged by silly people who misuse stocks to attempt to make short-term gains without understanding the nature of the beast. In fact, over time, stocks are an “upward meandering beast”. Ultimately, stock prices go where earnings go. Add in the return from dividends paid out and allow enough time for changes in price to earnings ratio to wash out so the result is $\text{Return} = \text{Earnings Growth} + \text{Dividend Yield}$ (refer back to Chapter 6).

