HOW CAN SMALL INVESTORS COPE WITH INFLATION?

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INFLATION - RECORD AND PROSPECT

In the ninety-year period from 1843 to 1933 the Consumer Price Index (1957-59 = 100) rose and fell five times, but in the thirty-seven year period 1933 to 1970 the CPI has risen steadily for a total of 300 per cent, an average of 5 1/2 per cent a year.[1] And the prospects are that the erosion of the dollar will continue. For the first time in our history we have two generations of consumers-savers-investors who have never experienced a significant appreciation of the dollar. In years past students of business cycles advised investors to buy fixed dollar investments on the down-swing of the cycle and growth investments on the upswing. What do they advise now?

If we try to predict the future on the record of the pase, the 20 years preceding 1969 show boom, occasional mild recessions, continuing inflation, rising interest rates, steady technical growth, rising taxes, constant war or threat of war, and adverse balance of payments.[2] Obviously, it is easier to evaluate the past than it is to predict the future. The successful (or lucky) investor is the one who can read (or guess) the economic indicators ahead.

SMALL INVESTORS FACE INFLATION

Small investors are understandably cautious. Security or principal is their primary concern. Security includes preservation of purchasing power, and one method of achieving such security is to diversify investments. Stability of real income is especially important to investors who have retired. As prices rise dollar income must rise. Also one's income from investments must grow as the economy grows. In the forseeable future this means that one's investments should grow no less than 8 per cent a year - 5 per cent to offset inflation, and 3 per cent to share in economic growth. To achieve this the experts recommend that no more than 30 to 40 per cent of one's portfolio should be in fixed dollar investments such as bonds, mortgages, and cash. The other 70 to 60 per cent should be in real estate, common stocks, or mutual funds.

Moving from generalizations to specifics, the small investor must ask: What bonds? What mortgages? What real estate? What common stocks? What mutual funds?

Federal government bonds are the standard by which all other bonds are judged. For the fixed dollar portion of a portfolio small investors are advised to buy United States savings bonds. Municipal and corporate bonds are not on the recommended list. Certificates of deposit in banks participating in the Federal Deposit Insurance Corporation are acceptable for the short term.

Individual mortgages have defects for small investors, chief of which is their lack of liquidity. A relatively new form of investment is the Mortgage Investment Trust, which resembles a mutual fund. It is a specialized finance company which

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[1] Joseph Mayer, "Inflation, Inc." Social Science 47:1 (Winter, 1972), p.4.

[2] John C. Clendenin, George A. Christy, Introduction to Investments, (New York: McGraw Hill, 5th ed., 1969), pp. 5-6.

invests in mortgages only. Because there is a fad element in the performance of most MIT issues, they are not recommended for small investors.[1] The Real Estate Investment Trust is designed to give small investors an opportunity to invest in real estate. They are regulated by the Securities and Exchange Commission and have performed well.[2]

COMMON STOCKS AND INFLATION

If the consumer price index continues to rise at the rate of 5 per cent a year you will need an income of $20,000 in 1985 to equal an income of $10,000 in 1971. How can a prospective retiree cope with such a challenge? One answer is to purchase corporate shares of stock. In the 98 year period 1871 to 1968 common stocks rose 2,989 per cent.[3]

Corporations grow with the economy; their earnings increase, and the prices of their shares increase. Freund concluded that in the long run stock price averages will grow 5 1/2 per cent a year of which 3 1/2 per cent will be real growth and 2 per cent will reflect inflation. Projecting dividends at 3 per cent annually, total yield will be 8 1/2 per cent. If these projections are valid, the risk one takes in not buying stocks is greater than the risk one takes in buying them.[4]

Looking backward for verification the University of Chicago Center for Research in Security Prices studied the performance of common stocks from 1926 to 1960. They found that a single random investment on the New York Stock Exchange would have been profitable in more than 75 per cent of the 56 million simulated transactions. Half the time the yield on a single random investment would have been 9.8 per cent a year compounded annually, assuming reinvestment of dividends and a 1 per cent brokerage fee. In the $10,000 income bracket, investors in common stocks, reinvesting their dividends would have had an 8.2 per cent yield.[5]

In a later study, equal initial investments in the common stock of each corporation listed on the New York Stock Exchange were analyzed for 820 time periods. From 1960 to 1965 the average rate of return was 15.9 per cent annually.[6]

Another way small investors can meet the challenge of continually rising prices is to purchase stock tied to the Consumer Price Index. The Farm Bureau Cooperative Association, Columbus, Ohio, pioneered in offering such a stock to

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[1] Stanley Schwartz, "Mortgage Investment Trusts", The Institutional Investor, 3 (July, 1969), pp. 80-100.

[2] Editorial Panel, American Research Council, $ Your Investments $, 18th ed., New York: McGraw-Hill, 1970), p. 163.

[3] Ibid., p. 20.

[4] William Freund, "Price Relationships of Equities to Profit and Fiscal Outlook" in John M. Lishan and David T. Crary, eds., The Investment Process, (Scranton, Pa., International Textbook Co., 1970), pp. 25-26.

[5] Lawrence Fisher and James H. Lorie, "Rates of Return on Investments in Common Stocks", Journal of Business 37 (January, 1964), pp. 1-9.

[6] Lawrence Fisher and James H. Lorie, "Rates of Return on Investments in Common Stocks: The Year-by-Year Record, 1962-65", Journal of Business, 41(July, 1968), pp. 291-316.

investors. Dividends on Landmark Cost of Living Common Stock range from a guaranteed minimum of 5 1/2 per cent to a maximum of 8 per cent. As the CPI rises 2.6 points dividends increase 1/4 of 1 per cent.

Building a portfolio for retirement income is not easy. One must adopt an investment philosophy and policy and stay with it. One must have psychological stability. There are no fool-proof rules. Good stocks can and do decline in bull markets. New issues are hazardous. Glamor stocks are not for the small investor. In a 44 year period it was found that the blue-chip stocks out-performed the high risk issues.

Before venturing into the stock market a small investor should have an adequate insurance program, a substantial savings account, and some equity in a house, according to most investment counselors. If he is fortunate enough to be employed by an institution which participates in Social Security, Teachers Insurance and Annuity Association, and College Retirement Equities Fund he may not need any additional insurance or retirement coverage. Both Social Security and College Retirement Equities Fund will give him some protection against inflation.

For those who must do their own investing one suggestion is to balance one's portfolio as the big buyers do. In the annual reports of College Equities Retirement Fund one will find a list of stocks chosen by full-time expert investors. In $ Your Investments $ one will find a list of heirloom stocks which have long records of growth and dividend payments. Other guides include the published portfolios of foundations and universities.

When a small investor starts a stock purchase plan he should buy at regular intervals and he should hold his stock. Buying and selling are not for the small investor.

DOLLAR AVERAGING

The experts recommend the investment of fixed sums at regular intervals, regardless of price movements, over a long period of time. This is called dollar averaging, a technique which makes it possible to buy more shares at low prices than at high prices. A dollar averaging plan may be started at any market level or in any phase of a cycle, but it must be continued for a least 10 years.[1]

THE MONTHLY INVESTMENT PLAN

The Monthly Investment Plan was started by members of the New York Stock Exchange, to provide a solution to the problem of when to buy. Under this plan a small investor may purchase a fraction of a share of a high-price stock. Actually he can buy stock by the dollar's worth. If he decides he can invest $20 a month his broker buys common stocks, crediting the number of shares to his account. Dividends may be used to purchase more stock, or taken in cash. The Monthly Investment Plan uses the dollar averaging principle. The plan is noncontractual, there is no loading charge, nor is there any penalty if a monthly payment is missed. The Monthly Investment Plan solves the problem of when to buy, but not what to buy. The assumption is that the participant will have made his own selection, or will depend on the recommendation of the brokerage firm with which he deals.

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[1] For more on dollar averaging see Clendenin and Christy, pp. 264-65; Jerome B. Cohen and Edward D. Zinbarg, Investment Analysis and Portfolio Management, (Homewood, Ill,; Richard D. Irwin, 1967), pp. 540-45; Louis Engel, How To Buy Stocks, (New York: Bantam Books, 1967), pp. 181-88; John W. Hazard, Choosing Tomorrow's Growth Stocks Today (GardenCity, N.Y.: Doubleday, 1968), ch. 10; $Your Investments $, pp. 191-93.

INVESTMENT CLUBS

An interesting and effective way to learn the basics of investment principles and practices is to participate in an ivestment club. Composed of 15 to 20 persons, an investment club meets monthly, and each member puts a specified number of dollars into the investment pool. Members discuss the state of the economy, the prospects for growth, the stock market, and particular stocks. They may choose a list of stocks for analysis, each member agreeing to make a comprehensive study and report. Brokers are interested in investment clubs and usually accept invitations to attend a meeting. Knowing that club members purchase three times as much stock for their personal accounts each month as they do for their club, brokers will execute buy and sell orders, hoping to develop individual clients.

Investment Clubs have performed reasonably well. Their record shows an annual growth rate of 8 per cent.[1]

MUTUAL FUNDS

In the early days mutual funds were organized and operated primarily for small investors who appreciated their professional management and diversification. If one security in a fund declines in price that decline might be offset by a rise in another security. The lower yields of some securities might be offset by higher yields from others. The greater risk of some issues is balanced by the greater security of others. In principle the mutual fund is sound; participants purchase a hedge against inflation as well as deflation.

What is the performance record of funds? A study made for the Securities and Exchange Commission found that on the average mutual fund performance did not differ much from what would have been achieved by an unmanaged portfolio consisting of the same proportions of common stocks, preferred stocks, corporate bonds, government bonds, and other assets as a composite portfolio of the funds. About half the funds performed better, and half not as well, as an unmanaged portfolio.[2] This finding means that the problem is to select a fund whose performance exceeds that of the market. This is just as difficult as to select good growth stocks.

In 1970 another study led to an even stronger conclusion. "Equally weighted or unweighted investment in New York Stock Exchange stocks would have resulted in a higher rate of return than that achieved by (196) mutual funds in the 1960-68 period as a while."[3]

Academic and government studies covering earlier periods have shown no consistent relationships between performance and size; between performance and management expenses; between performance and portfolio turnover; between performance sales charges. The year 1969 really tested mutual fund performance. The Arthur Lipper Corporation analyzed the performance of 376 funds and found that only

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[1]For more information about Investment Clubs write to National Association of Investment Clubs, 1515 East Eleven Mile Road, Royal Oak, MI., 48067 or Federation of Investment Clubs, 150 Broadway, New York, N.Y. 10038.

[2]A Study of Mutual Funds, House Report 2274, 87th Congress, 2d session (Washington, D.C., Superintendent of Documents, 1962), p. X.

[3]Irwin Friend, Marshall Blume, Jean Crockett, Mutual Funds and Other Institutional Investors: A New Perspective, (New York: McGraw-Hill - A Twentieth Century Fund Study, 1970, p. 28.

19 showed any gain over 1968. All others reported losses, some in excess of 25 per cent. Investors learned that "...They must be as discriminating in choosing a fund as they are in choosing a corporate stock."[1]

Participation in an open-end mutual fund is expensive. A typical entrance fee ranges from 7 1/2 to 9 1/2 per cent of one's investment. In addition there is a management fee, typically 1/2 of 1 per cent of net asset value each year. Also there are penalties for failure to complete a contract.

There are a few no-load funds whose records are good. Their only charge is an annual management fee of 1/2 of 1 per cent, which is reasonable.

SHOULD SMALL INVESTORS USE MUTUAL FUNDS?

Even the experts differ in their responses to this question. Among those who answer affirmatively are Graham, Dodd, and Cottle who have written that the small investor "may properly do his common stock purchasing through the medium of investment-fund shares."[2] Bellemore says that mutual funds meet small investors needs at prices they can afford.[3] Doane and Hurll recommend mutual fund shares for anyone who lacks the time and skill to study the market and who has less than $15,000 to invest over a long period of time.[4] In addition to giving buyers professional management and diversification, mutual funds give them a sense of security, according to Amling.[5] Friend, Blume, and Crockett, whose studies of fund performance, have been critical, nevertheless believe that funds serve a useful function. They offer small investors a convenient method of spreading risk at a reasonable cost, and they have raised the average return for small investors whose alternative was fixed dollar investments.[6]

On the negative side, Engel takes a dim view of funds, as compared with direct purchase of common stock.[7] Cohen and Zinbarg are cautious, but skeptical. They believe the mutual fund investor pays too much for convenience and management, that performance has been exaggerated, and that some odious practices are used in selling.[8]

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[1] John Cunniff, "Mutual Funds Had Their Troubles in 1969, Too." Daytona Beach Evening News (January 5, 1970), p. 11.

[2] Benjamin Graham, David L. Dodd, Sidney Cottle, Security Analysis: Principles and Techniques, 4th ed. (New York: McGraw-Hill, 1963), pp. 70-73.

[3] Douglas H. Bellemore, Investments: Principles, Practices, Analysis, 2d ed. (Cincinnati: South-Western Publishing Co., 1966), pp. 797-806.

[4] C. Russell Doane, Charles W. Hurll, Jr., Investment Trusts and Funds From the Investor's Point of View, (Great Barrington, MA., American Institute for Economic Research, Economic Education Bulletin XI:2, March, 1971), pp. 20-21.

[5] Frederick Amling, Investments: An Introduction to Analysis and Management, 2d ed. (Englewood Cliffs, N.J., Prentice-Hall, 1970), pp. 638-40.

[6] Irwin Friend, Marshall Blume, Jean Crockett, Mutual Funds and Other Institutional Investors: A New Perspective, (New York: A Twentieth Century Fund Study, McGraw-Hill, 1970), p. 3.

[7] Louis Engel, How To Buy Stocks: A Guide to Making More Money in the Market, (New York: Bantam Books, 1967) 9th Printing, 1970, Chapter 29.

[8] Jerome B. Cohen, Edward D. Zinbarg, Investment Analysis and Portfolio Management, (Homewood, Ill,; Richard D. Irwin, 1967), pp. 643-44.

The final decision rests with each individual. If one decides to use one or more mutual funds how does one select them? No final or continuing answer can be given. Doane and Hurll list approximately 230 funds, with particular information on 8, and one of which a beginning investor might safely choose. Also they provide some basic guidelines.

THE NEED FOR CAUTION AND INFORMATION

The naive notions held by many amateur investors and their disregard of ordinary rules of precaution are amazing. Their propensity for "tips" is difficult to explain, as is their susceptibility to get-rich-quick schemes. Doctors, ministers, teachers, and small business men are reported to be among the most gullible. The serious investor needs to be informed on general economic conditions now, in the near future, and in the long run. He needs to know how to identify industries having growth potential, and how to choose growth companies. He must be able to read financial reports, and to know from what sources to gain useful and dependable information. An investment plan requires accurate records for tax purposes, mechanical supervision of conversions, coupons, maturities, options, and rights.

All of this suggests that the challenge of coping with inflation is formidable. It is. But the reward for the effort is a retirement income whose growth will offset continuing inflation, at least in part.