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How Inflation Swindles the Equity Investor

by Warren E. Buffett

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The future for stocks looks bleak to one large investor who has interests in over thirty corporations. The reason, says Warren Buffett, is that corporate earnings on shareholders' equity have remained stuck at about 12 percent over the whole postwar period.

Back in the low-inflation years of the 1950's and early 1960's, that return towered over the interest rates on bonds, and millions of lucky investors enjoyed market appreciation as well. But bond yields have risen sharply since then to take account of inflation, while companies seem unable to improve on that 12 percent stock "coupon."

Buffett nevertheless believes that "stocks are probably still the best of all the poor alternatives in an era of inflation—at least, if you buy in at appropriate prices."

The central problem in the stock market is that the return on capital hasn't risen with inflation. It seems to be stuck at 12 percent.

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It is no longer a secret that stocks, like bonds, do poorly in an inflationary environment. We have been in such an environment for most of the past decade, and it has indeed been a time of troubles for stocks. But the reasons for the stock market's problems in this period are still imperfectly understood.

There is no mystery at all about the problems of bondholders in an era of inflation. When the value of the dollar deteriorates month after month, a security with income and principal payments denominated in those dollars isn't going to be a big winner. You hardly need a Ph.D. in economics to figure that one out.

It was long assumed that stocks were something else. For many years, the

conventional wisdom insisted that stocks were a hedge against inflation. The proposition was rooted in the fact that stocks are not claims against dollars, as bonds are, but represent ownership of companies with productive facilities. These investors believed, would retain their value in real terms, let the politicians print money as they might.

And why didn't it turn out that way? The main reason, I believe, is that stocks, in economic substance, are really very similar to bonds.

I know that this belief will seem eccentric to many investors. They will immediately observe that the return on a bond (the coupon) is fixed, while the return on an equity investment (the company's earnings) can vary substantially from one year to another. True enough. But anyone who examines the aggregate re-

turns that have been earned by companies during the postwar years will discover something extraordinary: the returns on equity have in fact not varied much at all.

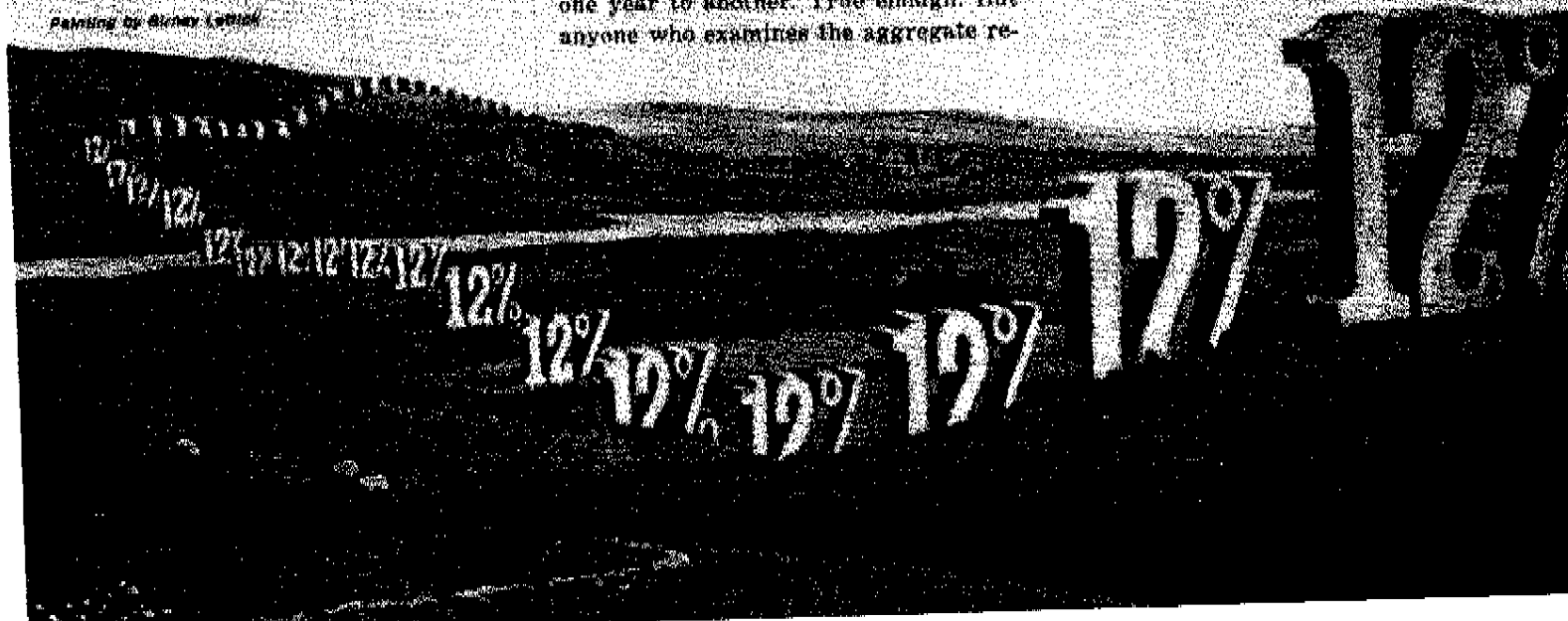
The coupon is sticky

In the first ten years after the war—the decade ending in 1955—the Dow Jones industrials had an average annual return on year-end equity of 12.8 percent. In the second decade, the figure was 10.1 percent. In the third decade it was 10.9 percent. Data for a larger universe, the FORTUNE 500 (whose history goes back only to the mid-1950's), indicate somewhat similar results: 11.2 percent in the decade ending in 1965, 11.8 percent in the decade through 1975. The figures for a few exceptional years have been substantially higher (the high for the 500 was 14.1 percent in 1974) or lower (9.5 percent in 1958 and 1970), but over the years, and in the aggregate, the return on book value tends to keep coming back to a level around 12 percent. It shows no signs of exceeding that level significantly in inflationary years (or in years of stable prices, for that matter).

For the moment, let's think of those companies, not as listed stocks, but as productive enterprises. Let's also assume that the owners of those enterprises had acquired them at book value. In that case, their own return would have been around 12 percent too. And because the return has been so consistent, it seems reasonable to think of it as an "equity coupon."

In the real world, of course, investors

Painting by Sidney Lattin



in stocks don't just buy and hold. Instead, many try to outwit their fellow investors in order to maximize their own proportions of corporate earnings. This thrashing about, obviously fruitless in aggregate, has no impact on the equity coupon but reduces the investor's portion of it, because he incurs substantial frictional costs, such as advisory fees and brokerage charges. Throw in an active options market, which adds nothing to the productivity of American enterprise but requires a cast of thousands to man the casino, and frictional costs rise farther.

Stocks are perpetual

It is also true that in the real world investors in stocks don't usually get to buy at book value. Sometimes they have been able to buy in below book; usually, however, they've had to pay more than book, and when that happens there is further pressure on that 12 percent. I'll talk more about these relationships later. Meanwhile, let's focus on the main point: as inflation has increased, the return on equity capital has not. Essentially, those who buy equities receive securities with an underlying fixed return—just like those who buy bonds.

Of course, there are some important differences between the bond and stock forms. For openers, bonds eventually come due. It may require a long wait, but eventually the bond investor gets to renegotiate the terms of his contract. If current and prospective rates of inflation make his old coupon look inadequate, he can refuse to play further unless coupons currently being offered rekindle his interest. Something of this sort has been going on in recent years.

Stocks, on the other hand, are perpetual. They have a maturity date of infinity. Investors in stocks are stuck with whatever return corporate America happens to earn. If corporate America is destined to earn 12 percent, then that is the level investors must learn to live with. As a group, stock investors can neither opt out nor renegotiate. In the

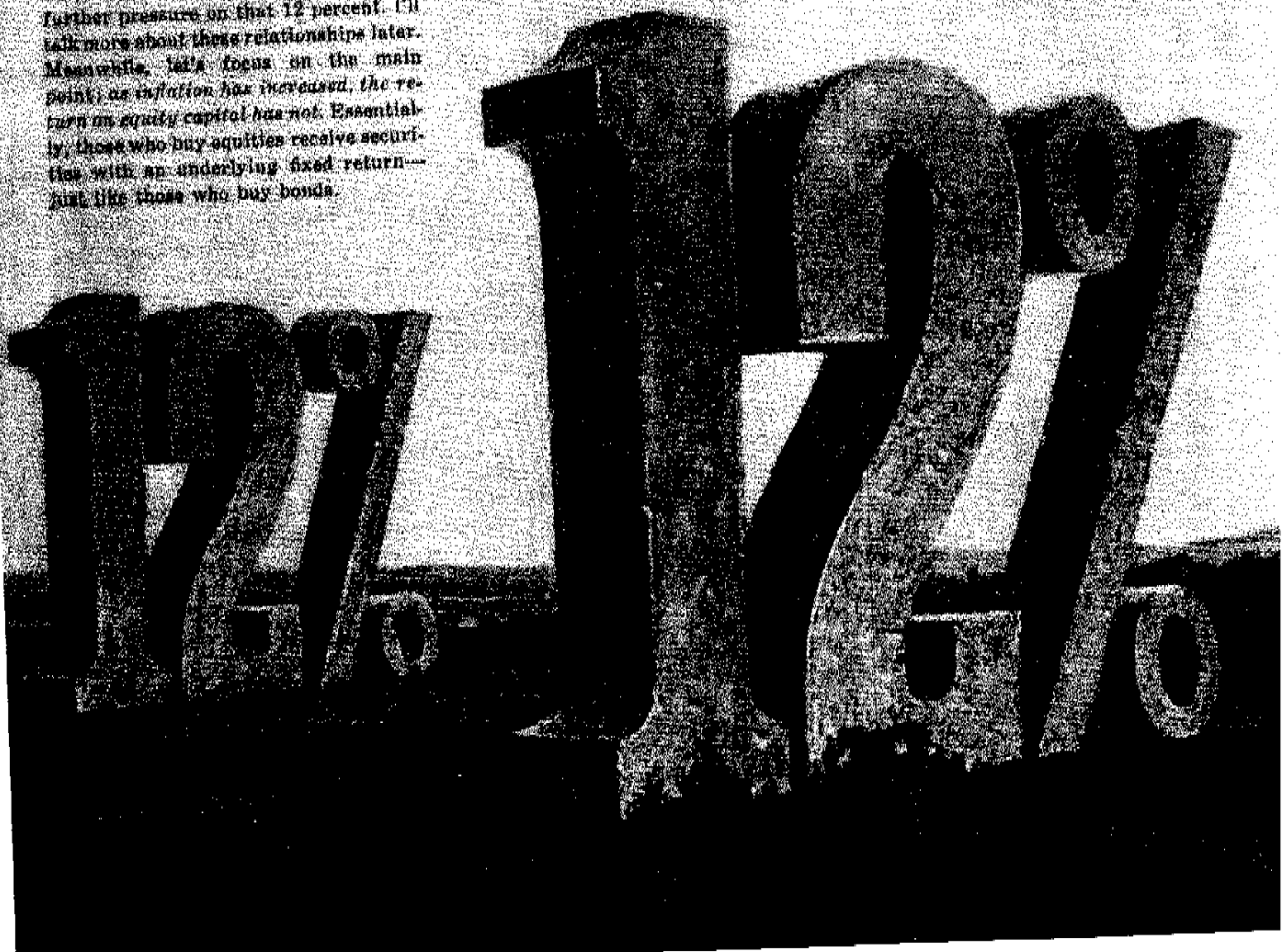
aggregate, their commitment is actually increasing. Individual companies can be sold or liquidated and corporations can repurchase their own shares; on balance, however, new equity flotations and retained earnings guarantee that the equity capital locked up in the corporate system will increase.

So, score one for the bond form: Bond coupons eventually will be renegotiated; equity "coupons" won't. It is true, of course, that for a long time a 12 percent coupon did not appear in need of a whole lot of correction.

The bondholder gets it in cash

There is another major difference between the garden variety of bond and our new exotic 12 percent "equity bond" that comes to the Wall Street costume ball dressed in a stock certificate.

In the usual case, a bond investor receives his entire coupon in cash and is left to reinvest it as best he can. Our



stock investor's equity coupon, in contrast, is partially retained by the company and is reinvested at whatever rates the company happens to be earning. In other words, going back to our corporate universe, part of the 12 percent earned annually is paid out in dividends and the balance is put right back into the universe to earn 12 percent also.

The good old days

This characteristic of stocks—the reinvestment of part of the coupon—can be good or bad news, depending on the relative attractiveness of that 12 percent. The news was very good indeed in the 1950's and early 1960's. With bonds yielding only 3 or 4 percent, the right to reinvest automatically a portion of the equity coupon at 12 percent was of enormous value. Note that investors could not just invest their own money and get that 12 percent return. Stock prices in this period ranged far above book value, and investors were prevented by the premium prices they had to pay from directly extracting out of the underlying corporate universe whatever rate that universe was earning. You can't pay far above par for a 12 percent bond and earn 12 percent for yourself.

But on their retained earnings, investors could earn 12 percent. In effect, earnings retention allowed investors to buy at book value part of an enterprise that, in the economic environment then existing, was worth a great deal more than book value.

It was a situation that left very little to be said for cash dividends and a lot to be said for earnings retention. Indeed, the more money that investors thought likely to be reinvested at the 12 percent rate, the more valuable they considered their reinvestment privilege, and the more they were willing to pay for it. In the early 1960's, investors eagerly paid top-scale prices for electric utilities situated in growth areas, knowing that these companies had the ability to reinvest very large proportions of their earnings. Utilities whose operating environment dictated a larger cash payout rated lower prices.

If, during this period, a high-grade, noncallable, long-term bond with a 12

percent coupon had existed, it would have sold far above par. And if it were a bond with a further unusual characteristic—which was that most of the coupon payments could be automatically reinvested at par in similar bonds—the issue would have commanded an even greater premium. In essence, growth stocks retaining most of their earnings represented just such a security. When their reinvestment rate on the added equity capital was 12 percent while interest rates generally were around 4 percent, investors became very happy—and, of course, they paid happy prices.

Heading for the exits

Looking back, stock investors can think of themselves in the 1946-66 period as having been ladled a truly bountiful triple dip. First, they were the beneficiaries of an underlying corporate return on equity that was far above prevailing interest rates. Second, a significant portion of that return was reinvested for them at rates that were otherwise unattainable. And third, they were afforded an escalating appraisal of underlying equity capital as the first two benefits became widely recognized. This third dip meant that, on top of the basic 12 percent or so earned by corporations on their equity capital, investors were receiving a bonus as the Dow Jones industrials increased in price from 133 percent of book value in 1946 to 220 percent in 1966. Such a marking-up process temporarily allowed investors to achieve a return that exceeded the inherent earning power of the enterprises in which they had invested.

This heaven-on-earth situation finally was "discovered" in the mid-1960's by many major investing institutions. But just as these financial elephants began trampling on one another in their rush to equities, we entered an era of accelerating inflation and higher interest rates. Quite logically, the marking-up process began to reverse itself. Rising interest rates ruthlessly reduced the value of all existing fixed-coupon investments. And as long-term corporate bond rates began moving up (eventually reaching the 10 percent area), both the equity return of 12 percent and the reinvest-

ment "privilege" began to look different.

Stocks are quite properly thought of as riskier than bonds. While that equity coupon is more or less fixed over periods of time, it does fluctuate somewhat from year to year. Investors' attitudes about the future can be affected substantially, although frequently erroneously, by those yearly changes. Stocks are also riskier because they come equipped with infinite maturities. (Even your friendly broker wouldn't have the nerve to peddle a 100-year bond, if he had any available, as "safe.") Because of the additional risk, the natural reaction of investors is to expect an equity return that is comfortably above the bond return—and 12 percent on equity versus, say, 10 percent on bonds issued by the same corporate universe does not seem to qualify as comfortable. As the spread narrows, equity investors start looking for the exits.

But, of course, as a group they can't get out. All they can achieve is a lot of movement, substantial frictional costs, and a new, much lower level of valuation, reflecting the lessened attractiveness of the 12 percent equity coupon under inflationary conditions. Bond investors have had a succession of shocks over the past decade in the course of discovering that there is no magic attached to any given coupon level: at 6 percent, or 8 percent, or 10 percent, bonds can still collapse in price. Stock investors, who are in general not aware that they too have a "coupon," are still receiving their education on this point.

Five ways to improve earnings

Must we really view that 12 percent equity coupon as immutable? Is there any law that says the corporate return on equity capital cannot adjust itself upward in response to a permanently higher average rate of inflation?

There is no such law, of course. On the other hand, corporate America cannot increase earnings by desire or decree. To raise that return on equity, corporations would need at least one of the following: (1) an increase in turnover, i.e., in the ratio between sales and total assets employed in the business; (2) cheaper leverage; (3) more leverage;

(4) lower income taxes; (5) wider operating margins on sales.

And that's it. There simply are no other ways to increase returns on common equity. Let's see what can be done with these.

We'll begin with *turnover*. The three major categories of assets we have to think about for this exercise are accounts receivable, inventories, and fixed assets such as plants and machinery.

Accounts receivable go up proportionally as sales go up, whether the increase in dollar sales is produced by more physical volume or by inflation. No room for improvement here.

With inventories, the situation is not quite so simple. Over the long term, the trend in unit inventories may be expected to follow the trend in unit sales. Over the short term, however, the physical turnover rate may bob around because of special influences—e.g., cost expectations, or bottlenecks.

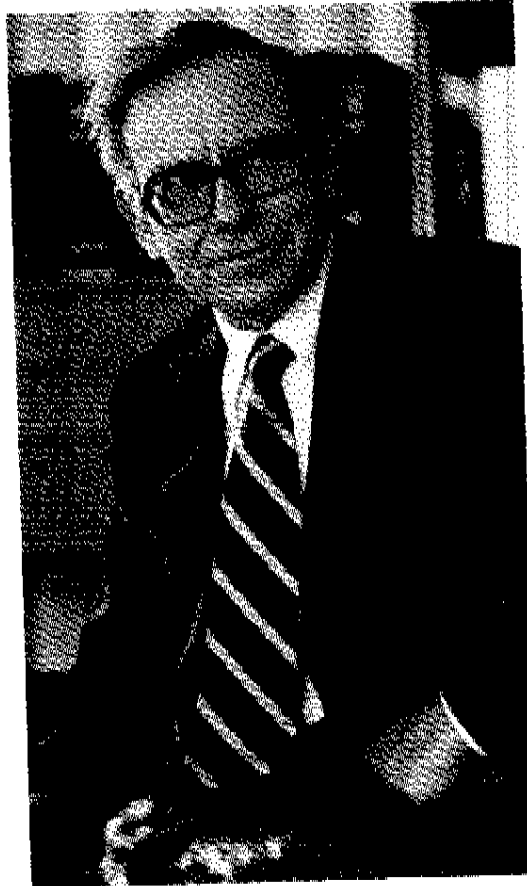
The use of last-in, first-out (LIFO) inventory-valuation methods serves to increase the reported turnover rate during inflationary times. When dollar sales are rising because of inflation, inventory valuations of a LIFO company either will remain level (if unit sales are not rising) or will trail the rise in dollar sales (if unit sales are rising). In either case, dollar turnover will increase.

During the early 1970's, there was a pronounced swing by corporations toward LIFO accounting (which has the effect of lowering a company's reported earnings and tax bills). The trend now seems to have slowed. Still, the existence of a lot of LIFO companies, plus the likelihood that some others will join the crowd, ensures some further increase in the reported turnover of inventory.

The gains are apt to be modest

In the case of fixed assets, any rise in the inflation rate, assuming it affects all products equally, will initially have the effect of increasing turnover. That is true because sales will immediately reflect the new price level, while the fixed-asset account will reflect the change only gradually, i.e., as existing assets are retired and replaced at the new prices. Obviously, the more slowly a company goes

WARREN BUFFETT IS IN STOCKS ANYWAY



The author is, in fact, one of the most visible stock-market investors in the U.S. these days. He's had plenty to invest for his own account ever since he made \$25 million running an investment partnership during the 1960's. Buffett Partnership Ltd., based in Omaha, was an immensely successful operation, but he nevertheless closed up shop at the end of the decade. A January, 1970, *FORTUNE* article explained his decision: "he . . . suspects that some of the juice has gone out of the stock market and that sizable gains in the future are going to be very hard to come by."

Buffett, who is now forty-six and still operating out of Omaha, has a diverse portfolio. He and businesses he controls have interests in over thirty public corporations. His major holdings: Berkshire Hathaway (he owns about \$35 million worth) and Blue Chip Stamps (about \$10 million). His visibility, recently increased by a *Wall Street Journal* profile, reflects his active managerial role in both companies, both of which invest in a wide range of enterprises; one is the *Washington Post*.

And why does a man who is gloomy about stocks own so much stock? "Partly, it's habit," he admits. "Partly, it's just that stocks mean business, and owning businesses is much more interesting than owning gold or farmland. Besides, stocks are probably still the best of all the poor alternatives in an era of inflation—at least they are if you buy in at appropriate prices."

about this replacement process, the more the turnover ratio will rise. The action stops, however, when a replacement cycle is completed. Assuming a constant rate of inflation, sales and fixed assets will then begin to rise in concert at the rate of inflation.

To sum up, inflation will produce some gains in turnover ratios. Some improvement would be certain because of LIFO, and some would be possible (if inflation accelerates) because of sales rising more rapidly than fixed assets. But the gains are apt to be modest and not of a magnitude to produce substantial improvement in returns on equity capital. During the decade ending in 1975, despite generally accelerating inflation and the extensive use of LIFO accounting, the turnover ratio of the *FORTUNE* 500 went only from 1.18/1 to 1.29/1.

Cheaper leverage? Not likely. High rates of inflation generally cause borrowing to become dearer, not cheaper. Galloping rates of inflation create galloping capital needs; and lenders, as they become increasingly distrustful of long-term contracts, become more demanding. But even if there is no further rise in interest rates, leverage will be getting more expensive because the average cost of the debt now on corporate books is less than would be the cost of replacing it. And replacement will be required as the existing debt matures. Overall, then, future changes in the cost of leverage seem likely to have a mildly depressing effect on the return on equity.

More leverage? American business already has fired many, if not most, of the more-leverage bullets once available to it. Proof of that proposition can be seen

in some other FORTUNE 500 statistics: in the twenty years ending in 1975, stockholders' equity as a percentage of total assets declined for the 500 from 63 percent to just under 50 percent. In other words, each dollar of equity capital now is leveraged much more heavily than it used to be.

What the lenders learned

An irony of inflation-induced financial requirements is that the highly profitable companies—generally the best credits—require relatively little debt capital. But the laggards in profitability never can get enough. Lenders understand this problem much better than they did a decade ago—and are correspondingly less willing to let capital-hungry, low-profitability enterprises leverage themselves to the sky.

Nevertheless, given inflationary conditions, many corporations seem sure in the future to turn to still more leverage as a means of shoring up equity returns. Their managements will make that move because they will need enormous amounts of capital—often merely to do the same physical volume of business—and will wish to get it without cutting dividends or making equity offerings that, because of inflation, are not apt to shape up as attractive. Their natural response will be to heap on debt, almost regardless of cost. They will tend to behave like those utility companies that argued over an eighth of a point in the 1960's and were grateful to find 12 percent debt financing in 1974.

Added debt at present interest rates, however, will do less for equity returns than did added debt at 4 percent rates in the early 1960's. There is also the problem that higher debt ratios cause credit ratings to be lowered, creating a further rise in interest costs.

* So that is another way, to be added to those already discussed, in which the cost of leverage will be rising. In total, the higher costs of leverage are likely to offset the benefits of greater leverage.

Besides, there is already far more debt in corporate America than is conveyed by conventional balance sheets. Many companies have massive pension obliga-

tions geared to whatever pay levels will be in effect when present workers retire. At the low inflation rates of 1955-65, the liabilities arising from such plans were reasonably predictable. Today, nobody can really know the company's ultimate obligation. But if the inflation rate averages 7 percent in the future, a twenty-five-year-old employee who is now earning \$12,000, and whose raises do no more than match increases in living costs, will be making \$180,000 when he retires at sixty-five.

Of course, there is a marvelously precise figure in many annual reports each year, purporting to be the unfunded pension liability. If that figure were really believable, a corporation could simply ante up that sum, add to it the existing pension-fund assets, turn the total amount over to an insurance company, and have it assume all the corporation's present pension liabilities. In the real world, alas, it is impossible to find an insurance company willing even to listen to such a deal.

Virtually every corporate treasurer in America would recoil at the idea of issuing a "cost-of-living" bond—a noncallable obligation with coupons tied to a price index. But through the private pension system, corporate America has in fact taken on a fantastic amount of debt that is the equivalent of such a bond.

More leverage, whether through conventional debt or unbooked and indexed "pension debt," should be viewed with skepticism by shareholders. A 12 percent return from an enterprise that is debt-free is far superior to the same return achieved by a business hocked to its eyeballs. Which means that today's 12 percent equity returns may well be less valuable than the 12 percent returns of twenty years ago.

More fun in New York

Lower corporate income taxes seem unlikely. Investors in American corporations already own what might be thought of as a Class D stock. The Class A, B, and C stocks are represented by the income-tax claims of the federal, state, and municipal governments. It is true that these "investors" have no claim on the

corporation's assets; however, they get a major share of the earnings, including earnings generated by the equity buildup resulting from retention of part of the earnings owned by the Class D shareholders.

A further charming characteristic of these wonderful Class A, B, and C stocks is that their share of the corporation's earnings can be increased immediately, abundantly, and without payment by the unilateral vote of any one of the "stockholder" classes, e.g., by congressional action in the case of the Class A. To add to the fun, one of the classes will sometimes vote to increase its ownership share in the business retroactively—as companies operating in New York discovered to their dismay in 1975. Whenever the Class A, B, or C "stockholders" vote themselves a larger share of the business, the portion remaining for Class D—that's the one held by the ordinary investor—declines.

Looking ahead, it seems unwise to assume that those who control the A, B, and C shares will vote to reduce their own take over the long run. The Class D shares probably will have to struggle to hold their own.

Bad news from the FTC

The last of our five possible sources of increased returns on equity is *wider operating margins on sales*. Here is where some optimists would hope to achieve major gains. There is no proof that they are wrong. But there are only 100 cents in the sales dollar and a lot of demands on that dollar before we get down to the residual, pretax profits. The major claimants are labor, raw materials, energy, and various non-income taxes. The relative importance of these costs hardly seems likely to decline during an age of inflation.

Recent statistical evidence, furthermore, does not inspire confidence in the proposition that margins will widen in a period of inflation. In the decade ending in 1965, a period of relatively low inflation, the universe of manufacturing companies reported on quarterly by the Federal Trade Commission had an average annual pretax margin on sales of 8.6

percent. In the decade ending in 1975, the average margin was 8 percent. Margins were down, in other words, despite a very considerable increase in the inflation rate.

If business was able to base its prices on replacement costs, margins would widen in inflationary periods. But the simple fact is that most large businesses, despite a widespread belief in their market power, just don't manage to pull it off. Replacement cost accounting almost always shows that corporate earnings have declined significantly in the past decade. If such major industries as oil, steel, and aluminum really have the oligopolistic muscle imputed to them, one can only conclude that their pricing policies have been remarkably restrained.

There you have the complete lineup: five factors that can improve returns on common equity, none of which, by my analysis, are likely to take us very far in that direction in periods of high inflation. You may have emerged from this exercise more optimistic than I am. But remember, returns in the 12 percent area have been with us a long time.

The investor's equation

Even if you agree that the 12 percent equity coupon is more or less immutable, you still may hope to do well with it in the years ahead. It's conceivable that you will. After all, a lot of investors did well with it for a long time. But your future results will be governed by three variables: the relationship between book value and market value, the tax rate, and the inflation rate.

Let's wade through a little arithmetic about book and market value. When stocks consistently sell at book value, it's all very simple. If a stock has a book value of \$100 and also an average market value of \$100, 12 percent earnings by business will produce a 12 percent return for the investor (less those frictional costs, which we'll ignore for the moment). If the payout ratio is 50 percent, our investor will get \$6 via dividends and a further \$6 from the increase in the book value of the business, which will, of course, be reflected in the market value of his holdings.

If the stock sold at 150 percent of book value, the picture would change. The investor would receive the same \$6 cash dividend, but it would now represent only a 4 percent return on his \$150 cost. The book value of the business would still increase by 6 percent (to \$106) and the market value of the investor's holdings, valued consistently at 150 percent of book value, would similarly increase by 6 percent (to \$159). But the investor's total return, i.e., from appreciation plus dividends, would be only 10 percent versus the underlying 12 percent earned by the business.

When the investor buys in below book value, the process is reversed. For example, if the stock sells at 80 percent of book value, the same earnings and payout assumptions would yield 7.5 percent from dividends (\$6 on an \$80 price) and 6 percent from appreciation—a total return of 13.5 percent. In other words, you do better by buying at a discount rather than a premium, just as common sense would suggest.

During the postwar years, the market value of the Dow Jones industrials has been as low as 84 percent of book value (in 1974) and as high as 232 percent (in 1965); most of the time the ratio has been well over 100 percent. (Early this spring, it was around 110 percent.) Let's assume that in the future the ratio will be something close to 100 percent—meaning that investors in stocks could earn the full 12 percent. At least, they could earn that figure before taxes and before inflation.

7 percent after taxes

How large a bite might taxes take out of the 12 percent? For individual investors, it seems reasonable to assume that federal, state, and local income taxes will average perhaps 50 percent on dividends and 30 percent on capital gains. A majority of investors may have marginal rates somewhat below these, but many with larger holdings will experience substantially higher rates. Under the new tax law, as FORTUNE observed last month, a high-income investor in a heavily taxed city could have a marginal rate on capital gains as high as 56 percent. (See

"The Tax Practitioners Act of 1976.")

So let's use 50 percent and 30 percent as representative for individual investors. Let's also assume, in line with recent experience, that corporations earning 12 percent on equity pay out 5 percent in cash dividends (2.5 percent after tax) and retain 7 percent, with those retained earnings producing a corresponding market-value growth (4.9 percent after the 30 percent tax). The after-tax return, then, would be 7.4 percent. Probably this should be rounded down to about 7 percent to allow for frictional costs. To push our stocks-as-disguised-bonds thesis one notch further, then, stocks might be regarded as the equivalent, for individuals, of 7 percent tax-exempt perpetual bonds.

The number nobody knows

Which brings us to the crucial question—the inflation rate. No one knows the answer on this one—including the politicians, economists, and Establishment pundits, who felt, a few years back, that with slight nudges here and there unemployment and inflation rates would respond like trained seals.

But many signs seem negative for stable prices: the fact that inflation is now worldwide; the propensity of major groups in our society to utilize their electoral muscle to shift, rather than solve, economic problems; the demonstrated unwillingness to tackle even the most vital problems (e.g., energy and nuclear proliferation) if they can be postponed; and a political system that rewards legislators with reelection if their actions appear to produce short-term benefits even though their ultimate imprint will be to compound long-term pain.

Most of those in political office, quite understandably, are firmly against inflation and firmly in favor of policies producing it. (This schizophrenia hasn't caused them to lose touch with reality, however; Congressmen have made sure that *their* pensions—unlike practically all granted in the private sector—are indexed to cost-of-living changes *after* retirement.)

Discussions regarding future inflation rates usually probe the subtleties of

monetary and fiscal policies. These are important variables in determining the outcome of any specific inflationary equation. But, at the source, peacetime inflation is a political problem, not an economic problem. Human behavior, not monetary behavior, is the key. And when very human politicians choose between the next election and the next generation, it's clear what usually happens.

Such broad generalizations do not produce precise numbers. However, it seems quite possible to me that inflation rates will average 7 percent in future years. I hope this forecast proves to be wrong. And it may well be. Forecasts usually tell us more of the forecaster than of the future. You are free to factor your own inflation rate into the investor's equation. But if you foresee a rate averaging 2 percent or 3 percent, you are wearing different glasses than I am.

So there we are: 12 percent before taxes and inflation; 7 percent after taxes and before inflation; and maybe zero percent after taxes and inflation. It hardly sounds like a formula that will keep all those cattle stampeding on TV.

As a common stockholder you will have more dollars, but you may have no more purchasing power. Out with Ben Franklin ("a penny saved is a penny earned") and in with Milton Friedman ("a man might as well consume his capital as invest it").

What widows don't notice

The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital. It makes no difference to a widow with her savings in a 5 percent passbook account whether she pays 100 percent income tax on her interest income during a period of zero inflation, or pays *no* income taxes during years of 5 percent inflation. Either way, she is "taxed" in a manner that leaves her no real income whatsoever. Any money she spends comes right out of capital. She would find outrageous a 120 percent income tax, but doesn't seem to notice that 6 percent inflation is the economic equivalent.

If my inflation assumption is close to correct, disappointing results will occur not because the market falls, but in spite of the fact that the market rises. At around 920 early last month, the Dow was up fifty-five points from where it was ten years ago. But adjusted for inflation, the Dow is down almost 345 points—from 865 to 520. And about half of the earnings of the Dow had to be withheld from their owners and reinvested in order to achieve even that result.

In the next ten years, the Dow would be doubled just by a combination of the 12 percent equity coupon, a 40 percent payout ratio, and the present 110 percent ratio of market to book value. And with 7 percent inflation, investors who sold at 1800 would still be considerably worse off than they are today after paying their capital-gains taxes.

I can almost hear the reaction of some investors to these downbeat thoughts. It will be to assume that, whatever the difficulties presented by the new investment era, they will somehow contrive to turn in superior results for themselves. Their success is most unlikely. And, in aggregate, of course, impossible. If you feel you can dance in and out of securities in a way that defeats the inflation tax, I would like to be your broker—but not your partner.

Even the so-called tax-exempt investors, such as pension funds and college endowment funds, do not escape the inflation tax. If my assumption of a 7 percent inflation rate is correct, a college treasurer should regard the first 7 percent earned each year merely as a replenishment of purchasing power. Endowment funds are earning *nothing* until they have outpaced the inflation treadmill. At 7 percent inflation and, say, overall investment returns of 8 percent, these institutions, which believe they are tax-exempt, are in fact paying "income taxes" of 87½ percent.

The social equation

Unfortunately, the major problems from high inflation rates flow not to investors but to society as a whole. Investment income is a small portion of national income, and if per capita real

income could grow at a healthy rate alongside zero real investment returns, social justice might well be advanced.

A market economy creates some lopsided payoffs to participants. The right endowment of vocal chords, anatomical structure, physical strength, or mental powers can produce enormous piles of claim checks (stocks, bonds, and other forms of capital) on future national output. Proper selection of ancestors similarly can result in lifetime supplies of such tickets upon birth. If zero real investment returns diverted a bit greater portion of the national output from such stockholders to equally worthy and hard-working citizens lacking jackpot-producing talents, it would seem unlikely to pose such an insult to an equitable world as to risk Divine Intervention.

But the potential for real improvement in the welfare of workers at the expense of affluent stockholders is not significant. Employee compensation already totals twenty-eight times the amount paid out in dividends, and a lot of those dividends now go to pension funds, nonprofit institutions such as universities, and individual stockholders who are not affluent. Under these circumstances, if we now shifted *all* dividends of wealthy stockholders into wages—something we could do only once, like killing a cow (or, if you prefer, a pig)—we would increase real wages by less than we used to obtain from one year's growth of the economy.

The Russians understand it too

Therefore, diminishment of the affluent, through the impact of inflation on their investments, will not even provide material *short-term* aid to those who are not affluent. Their economic well-being will rise or fall with the general effects of inflation on the economy. And those effects are not likely to be good.

Large gains in real capital, invested in modern production facilities, are required to produce large gains in economic well-being. Great labor availability, great consumer wants, and great government promises will lead to nothing but great frustration without continuous creation and employment of ex-

pensive new capital assets throughout industry. That's an equation understood by Russians as well as Rockefellers. And it's one that has been applied with stunning success in West Germany and Japan. High capital-accumulation rates have enabled those countries to achieve gains in living standards at rates far exceeding ours, even though we have enjoyed much the superior position in energy.

To understand the impact of inflation upon real capital accumulation, a little math is required. Come back for a moment to that 12 percent return on equity capital. Such earnings are stated after depreciation, which presumably will allow replacement of present productive capacity—if that plant and equipment can be purchased in the future at prices similar to their original cost.

The way it was

Let's assume that about half of earnings are paid out in dividends, leaving 6 percent of equity capital available to finance future growth. If inflation is low—say, 2 percent—a large portion of that growth can be real growth in physical output. For under these conditions, 2 percent more will have to be invested in receivables, inventories, and fixed assets next year just to duplicate this year's physical output—leaving 4 percent for investment in assets to produce more physical goods. The 2 percent finances illusory dollar growth reflecting inflation and the remaining 4 percent finances real growth. If population growth is 1 percent, the 4 percent gain in real output translates into a 3 percent gain in real per capita net income. That, very roughly, is what used to happen in our economy.

Now move the inflation rate to 7 percent and compute what is left for real growth after the financing of the mandatory inflation component. The answer is nothing—if dividend policies and leverage ratios remain unchanged. After half of the 12 percent earnings are paid out, the same 6 percent is left, but it is all conscripted to provide the added dollars needed to transact last year's physical volume of business.

Many companies, faced with no real retained earnings with which to finance physical expansion after normal dividend payments, will improvise. How, they will ask themselves, can we stop or reduce dividends without risking stockholder wrath? I have good news for them: a ready-made set of blueprints is available.

In recent years the electric-utility industry has had little or no dividend-paying capacity. Or, rather, it has had the power to pay dividends *if* investors agree to buy stock from them. In 1975 electric utilities paid common dividends of \$3.3 billion and asked investors to return \$3.4 billion. Of course, they mixed in a little solicit-Peter-to-pay-Paul technique so as not to acquire a Con Ed reputation. Con Ed, you will remember, was unwise enough in 1974 to simply tell its shareholders it didn't have the money to pay the dividend. Candor was rewarded with calamity in the marketplace.

The more sophisticated utility maintains—perhaps increases—the quarterly dividend and then asks shareholders (either old or new) to mail back the money. In other words, the company issues new stock. This procedure diverts massive amounts of capital to the tax collector and substantial sums to underwriters. Everyone, however, seems to remain in good spirits (particularly the underwriters).

More joy at A.T.&T.

Encouraged by such success, some utilities have devised a further shortcut. In this case, the company declares the dividend, the shareholder pays the tax, and—presto—more shares are issued. No cash changes hands, although the IRS, spoilsport as always, persists in treating the transaction as if it had.

A.T.&T., for example, instituted a dividend-reinvestment program in 1973. This company, in fairness, must be described as very stockholder-minded, and its adoption of this program, considering the folkways of finance, must be regarded as totally understandable. But the substance of the program is out of *Alice in Wonderland*.

In 1976, A.T.&T. paid \$2.3 billion in

cash dividends to about 2.9 million owners of its common stock. At the end of the year, 648,000 holders (up from 601,000 the previous year) reinvested \$432 million (up from \$327 million) in additional shares supplied directly by the company.

Just for fun, let's assume that all A.T.&T. shareholders ultimately sign up for this program. In that case, no cash at all would be mailed to shareholders—just as when Con Ed passed a dividend. However, each of the 2.9 million owners would be notified that he should pay income taxes on his share of the retained earnings that had that year been called a "dividend." Assuming that "dividends" totaled \$2.3 billion, as in 1976, and that shareholders paid an average tax of 30 percent on these, they would end up, courtesy of this marvelous plan, paying nearly \$700 million to the IRS. Imagine the joy of shareholders, in such circumstances, if the directors were then to double the dividend.

The government will try to do it

We can expect to see more use of disguised payout reductions as business struggles with the problem of real capital accumulation. But throttling back shareholders somewhat will not entirely solve the problem. A combination of 7 percent inflation and 12 percent returns will reduce the stream of corporate capital available to finance real growth.

And so, as conventional private capital-accumulation methods falter under inflation, our government will increasingly attempt to influence capital flows to industry, either unsuccessfully as in England or successfully as in Japan. The necessary cultural and historical underpinning for a Japanese-style enthusiastic partnership of government, business, and labor seems lacking here. If we are lucky, we will avoid following the English path, where all segments fight over division of the pie rather than pool their energies to enlarge it.

On balance, however, it seems likely that we will hear a great deal more as the years unfold about underinvestment, stagflation, and the failures of the private sector to fulfill needs. END