

AN EXAMPLE OF THE RELATIVE BEHAVIOR OF BONDS AND STOCKS IN A PERIOD OF ACCELERATED INFLATION

For those concerned about the possibility of a ratcheting up of the rate of inflation, and wondering how best to prepare their investment portfolios for such a contingency, the U. S. experience in the 1970s and early 1980s seems instructive.

The bout of accelerated inflation that we experienced in this period, some three and four decades ago, was precipitated by the energy crisis which, in turn, was caused by the peaking of U. S. oil production in 1970, the Arab OPEC oil embargo in 1973, and the Iranian Revolution in 1979.

As measured by the Consumer Price Index, the rate of inflation, in a period of less than 8 years, between August 1972 and April 1980, jumped over five-fold, from 2.9% per year to 14.7% per year. Over the 8-year period 1973-1981, the rate of inflation averaged 9.27% per year.

As a proxy for how the typical bond investor might have fared during the 1970s and early 1980s we use the Franklin U. S. Government Securities mutual fund¹. Though the income generated by this fund grew with rising interest rates over this period, the fund's net asset value per share declined 49%, from \$11.08 in March 1971 to \$5.68 in September 1981. Putting together the rising interest income and the declining net asset value, over the 8-year period 1973-1981, the fund generated an average total return of +1.95% per year. Adjusting for inflation, this amounted to a negative average "real" rate of return of -7.32% per year over the period.

In contrast, the indicated average rate of return of a randomly selected, unmanaged portfolio of U. S. common stocks over this 8-year period, as measured by the Wilshire 5000 Equal Weight Total Market Index of U. S. common stocks was

+26.40% per year and, adjusting for inflation, the indicated “real” rate of return over the period was a positive +17.13% per year².

<u>AVERAGE ANNUAL RATES OF CHANGE OR RETURN OVER THE 8-YEAR PERIOD 1973-1981</u>		
<u>INDEX</u>	<u>NOMINAL RATE</u>	<u>“REAL” RATE³</u>
Consumer Price Index (CPI)	+9.27%	-
Bonds (Franklin US Government Securities Fund)	+1.95%	-7.32%
Stocks (Wilshire 5000 Equal Weight Total Market Index)	+26.40%	+17.13%

A legitimate inference from the foregoing bit of U. S. history would seem to be that bond returns tend to be negatively correlated with the rate of inflation, while stock returns tend to be positively correlated to the rate of inflation, and that, therefore, bonds could be a poor way to prepare for the possibility of a period of rising prices while common stocks might be a prudent way to prepare for such an eventuality.

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¹ As of this writing there are 26,634 mutual funds in the Thomson Reuters database available for purchase by the investing public. This same database also indicates that, in 1973, there were only 182 mutual funds available to the public that are still in existence today. Only a few of these 193 funds were bond funds and the Franklin U. S. Government Securities Fund appears to have been about the highest quality bond fund available at the time.

² Covering 166 times as many stocks as the 30-stock Dow Jones Industrial Average, and 10 times as many stocks as the Standard & Poor's 500 Composite, the Wilshire 5000 Total Market Index is regarded as the broadest and most comprehensive index measuring the performance of the U. S. stock market. The equally-weighted version of the index also provides a more realistic portfolio performance benchmark than the capitalization-weighted version, in that the size of security positions in actively managed portfolios are rarely, if ever, equated to their capitalization positions in the U. S. economy; and, for individual portfolios, prudent diversification generally dictates approximately equally-weighted positions. This benchmark, then, should indicate the expected performance of randomly selected, broadly diversified, unmanaged portfolios of U. S. stocks, with just as many portfolios outperforming the benchmark as underperforming it.

³ A “real” rate of return is defined as the nominal rate of return minus the rate of inflation.