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WHY COMMON STOCKS HAVE TENDED TO BE A GOOD HEDGE AGAINST INFLATION

Let us suppose we have a company that currently manufactures 1,000,000 widgets per year which it sells @ $100 each, and that its current income statement is summarized in Table 1. Let us also assume that our stock currently sells in the marketplace at 15 times earnings which produces a price of $45 per share.

TABLE 1

Sales (1,000,000 x $100)	$100,000,000
Cost of Raw Materials	20,000,000
Labor Costs	40,000,000
Profit Before Taxes	$40,000,000
Taxes	10,000,000
Profit After Taxes	$30,000,000
Shares Outstanding	10,000,000
Earnings Per Share	$3.00
Share Price @15 x EPS	$45

Let us next suppose that we experience a period of inflation over which the prices of almost everything doubles. Assuming that all other variables remain the same, our new income statement is summarized in Table 2. If our stock still sells at 15 times earnings, it will now be worth $90 per share. It has doubled in price just like almost everything else has doubled in price.

TABLE 2

Sales (1,000,000 x $200)	$200,000,000
Cost of Raw Materials	40,000,000
Labor Costs	80,000,000
Profit Before Taxes	$80,000,000
Taxes	20,000,000
Profit After Taxes	$60,000,000
Shares Outstanding	10,000,000
Earnings Per Share	$6.00
Share Price @ 15 x EPS	$90

The questionable assumption in the foregoing, of course, is "that all other variables remain the same." But that is always a problem with common stocks, with or without inflation. If prices collectively and on average double, our raw material and labor costs may rise more, or they may rise less. We may not be able to double the price we charge for widgets or we may be able to more than double the price. Our tax rate may be higher or lower down the road, and our stock may sell at more or less than 15 times earnings at this future date.

The important point is that these variables are just as apt to deviate in our favor as they are to deviate to our detriment and, collectively, for the economy as a whole, and over time, they should remain just about the same.

Not included in our hypothetical income statement is a provision for depreciation. If, after our period of inflation, we are still producing our widgets in the same factory, our charge for depreciation may not have gone up at all, in which case our profit after taxes and earnings per share should have more than doubled. The more fixed assets we have, the greater our leverage.

If we should be fortunate enough to have a company that grows by 50% and, at the end of our hypothetical period, we are producing and selling 1,500,000 widgets per year, the above arithmetic results in our stock's tripling in price to $135 per share, with half our gain coming from real growth and half coming from inflation.

One fly in the ointment could be the behavior of interest rates in a period of a rising rate of inflation. If the Federal Reserve is attempting to restrain the rate of inflation, it may elect to ratchet up interest rates, which could prove inimical to the number of widgets we sell, the price at which we sell them, and the price-earnings multiple accorded to our stock in the marketplace.

If, however, the economy is weak and we are experiencing a period of "stagflation," as we did in the 1970s, the Federal Reserve may conclude that a high rate of inflation is a lesser price to pay than a high rate of unemployment and so try to keep interest rates down as it is doing today. But, even if we need to endure the discomfort of rising interest rates for a while, the damage done will, in all likelihood be undone, when interest rates come back down again, as they did between 1982 and 2000, helping to produce what became greatest bull market in our nation's history.

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