The Tradeoff: Preserving Capital or Preserving Purchasing Power

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Many aspects of life require careful consideration and balancing of the tradeoffs that arise from competing demands. For example, a common lifestyle tradeoff is working longer hours versus spending more time with your family. The competing demands within this decision are the income necessary to provide a suitable quality of life *for* your family versus the immeasurable benefits of quality time *with* your family. There is no right answer, but most people understand the tradeoff and attempt to find the balance that is right for them.

Successful investing and financial planning also require balancing tradeoffs. For example, a common investment tradeoff is that of risk and return. One of the competing demands is preservation of capital versus preservation of purchasing power. The former may allow for a better night's sleep during periods of heightened uncertainty and corresponding volatility, but the latter helps ensure you'll have a comfortable bed in the future when accounting for rising prices from inflation. Once again, there is no right answer, no "optimal" solution. Understanding the tradeoffs between preserving capital and preserving purchasing power will help investors find the balance that is right for them. This balance will depend on their definition of risk and attitude towards it.

Some investors may consider risk to be volatility. They have difficulty stomaching the daily ups and downs associated with investing in asset classes that experience significant price fluctuations, such as equities, because declining prices are often accompanied by predominantly negative headlines. Although information will be reflected in prices before one can react to it, this is little solace to investors who extrapolate the recent past into the future and see the bad news as an indicator of what's to come rather than a commentary on what has already happened. These investors yearn for short-term preservation of capital.

Other investors may define risk as a diminishing standard of living. They have long-term financial obligations, such as spending during their retirement years, and their primary goal is building wealth to meet those future expenses. They recognize that, while the cumulative effects of inflation are sometimes glacially slow or even undetectable in real time, inflation can be the silent killer of a financial plan. These investors desire long-term preservation of purchasing power.

Investing is relatively straightforward when the definition of risk and attitude toward it are so black and white. For example, you can virtually guarantee the preservation of capital by investing in the equivalent of Treasury bills as long as you accept the corresponding potential for the loss of purchasing power. On the other hand, you can preserve purchasing power by investing in asset classes with expected returns exceeding inflation, providing you accept price fluctuations that can temporarily impair your capital.

Unfortunately, in practice, investing isn't that simple. Individual investors rarely have black and white objectives or well-defined definitions of and attitudes towards risk. Some expect long-term preservation of purchasing power *and* short-term preservation of capital. Making matters worse is the tendency for the priority and relative importance of their competing demands to change through time, often in response to what's happened in the recent past.

Investors who succumb to the cycle of fear and greed end up chasing a moving target. Advisors can try to mitigate this destructive behavior by focusing investors on the tradeoffs that were made at the outset when determining their balance between assets that are expected to grow faster than inflation and those that stabilize the portfolio and reduce its fluctuations. So if an investor is now fearful and therefore more focused on capital preservation, it is time to reframe the tradeoffs by emphasizing why growth assets were in the portfolio to begin with and how the so-called "riskless" asset (i.e., bills) can actually be extremely risky in the long run.

For example, Table 1 contains annualized returns from Australia, Canada, the US, and the UK for more than a century. Bills only slightly beat inflation before tax, but this small return advantage can easily disappear on an after-tax basis.[1] Nonetheless, the table clearly demonstrates that equities have delivered returns exceeding both bills and inflation by a wide margin, even when accounting for taxes.[2]

Table 1: Annualized Nominal Returns (1900–2010)

Country	Inflation	Bills	Equities
Australia	3.9%	4.6%	11.6%
Canada	3.0%	4.7%	9.1%
US	3.0%	3.9%	9.4%
UK	3.9%	5.0%	9.5%

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

However, the tradeoff for pursuing higher expected returns of equities is accepting the risk of substantial declines compared to the relative stability of bills. Table 2 shows that equity values in the four markets have dropped from 50–69% over a two- to six-year period, whereas bills have always been flat or better (if you consider minus 2 basis points a rounding error).

Table 2: Worst Performing Periods for Equities and Bills, Nominal Returns (1900–2010)

	Equities		Bills	
Country	Period	Total Return	Period	Total Return
Australia	1970–1974	–50%	1950	0.75%
Canada	1929–1934	–64%	1945	0.37%
US	1929–1932	–69%	1938	–0.02%
UK	1973–1974	–61%	1935	0.50%

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

The risk and return relationship from a preservation of capital perspective is apparent in these nominal returns, but the picture is a bit different after considering the impact of inflation. In terms of preserving purchasing power, now the "riskless" asset looks far from risk free.

Table 3 contains the biggest peak-to-trough declines, in real terms, for equities in these four countries over the same time period. It likely comes as no surprise that the magnitude of the real declines is substantial, with stock prices dropping anywhere from 55–71% after inflation. However, the duration of the declines is still relatively short, ranging from two to five years, and it took equity investors in these countries anywhere from three to eleven years to break even.

Table 3: Worst Performing Periods for Equities, Real Returns (1900–2010)

	Peak to Trough Decline			Subsequent Recovery
Country	Period	Total Return	Years	Years
Australia	1970–1974	–66%	5	11
Canada	1929–1932	–55%	4	3
US	1929–1931	–60%	4	4
UK	1973–1974	–71%	2	9

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

In contrast, the data in Table 4 for bills, or the "riskless" asset, in these four countries is revealing. The biggest peak-to-trough declines after inflation now remarkably range from 44–61%, a similar order of magnitude to equities. Furthermore, the duration of the declines extends to a range of seven to forty-one years with investors in bills waiting an astounding seven to forty-eight years to recover!

Table 4: Worst Performing Periods for Bills, Real Returns (1900–2010)

	Peak to Trough Decline			Subsequent Recovery
Country	Period	Total Return	Years	Years
Australia	1937–1977	–61%	41	21
Canada	1934–1951	–44%	18	34
US	1933–1951	–47%	19	48
UK	1914–1920	–50%	7	7

In local currency. Dimson Marsh Staunton (DMS) Global Returns Database. Past performance is no guarantee of future results.

More than ever, comparisons like these are needed when discussing the tradeoff of preserving capital versus preserving purchasing power. Investors feel the risk of equities in real time. Volatility is immediate and apparent as their portfolio value shows up in the mail every month or on their computer screen every day. Conversely, the risk of investing in bills and other low-volatility assets is less discernible and may take time to detect as it shows up when investors open their wallet at the grocery store or gas station many years later.

Investors may still want to revisit the tradeoffs they made and alter course if appropriate. However, changes to a long-term plan should reflect an informed decision rather than an emotional one. Fear and greed are powerful forces, but we should resist letting them dictate the tradeoffs we make in our lives or in our portfolios.

As the Most Interesting Man in the World would say, "stay invested, my friends!"

Many thanks to Marlena Lee for compiling this data from the Dimson Marsh Staunton (DMS) Global Returns Database.

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1. Returns in this table are pre-tax, but actual consumption, as represented by inflation, requires after-tax dollars; therefore, if the marginal tax rate on interest income exceeds [1 – (Inflation/Bill Return)], the real return is negative. (e.g., Canada: [1 – (3.0/4.7)] = 36% but the highest marginal tax rate on income is roughly 45%.)

2. The difference in the real return of equities versus bills would increase after taxes in countries where the tax rate on income exceeds the tax rate on dividends and capital gains.