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Does inflation swindle the equity investor?

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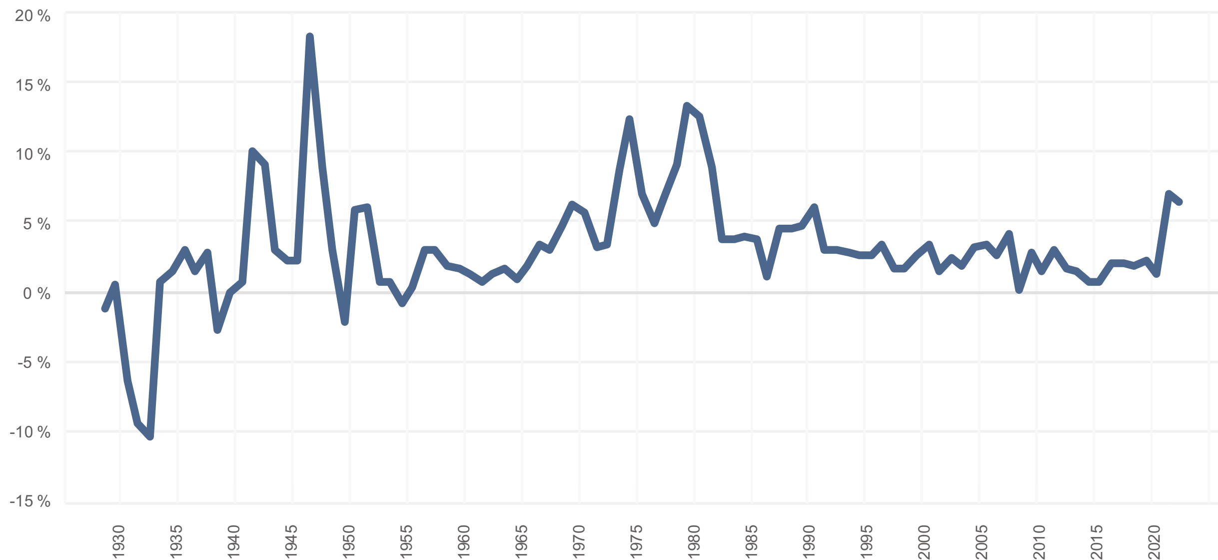
Key Insights

- *In a 1977 Fortune article titled "How Inflation Swindles the Equity Investor", Warren Buffett argued that stocks do not work as a hedge against inflation. Seemingly frustrated by the lackluster stock markets of the 1970s, he concluded that stocks are "very similar to bonds".*

- *In this note, we examine that notion. We highlight similarities and differences between the 1970s and today for stocks as an aggregate. We conclude that equity investors may suffer during times of high inflation, but not necessarily for the reasons Mr. Buffett suggested. In recent history, equities have indeed worked as a hedge against inflation.*

Figure 1

US inflation rate (CPI)



Source: Aswath Damodaran (NYU Stern) as of August 2023

"Inflation is not something that befalls companies. Rather, it is caused by them."

Inflation and corporations

Inflation measures how much more expensive goods and services have become. Most goods and services are provided by companies of some sort (private, public, government-owned, etc.), so when the prices of goods and services rise, companies' revenues increase.

Consequently, inflation is not something that befalls companies. Rather, it is caused by them; it is the average of all their price increases. Some companies may raise prices sooner or by more than others but, on average, companies are not only hedged against inflation – they create it.

Since one company's output is another company's input, prices/revenue and costs tend to rise in tandem. If revenue and costs rise at the same pace, margins will be unchanged, and thus profits rise too. In theory, inflation should not matter for companies or their shareholders.

In figure 1, we illustrate the rate of inflation in the United States from 1928 until today. The average inflation rate during this period was 3.0%.

Stocks, bonds, and inflation in the last century

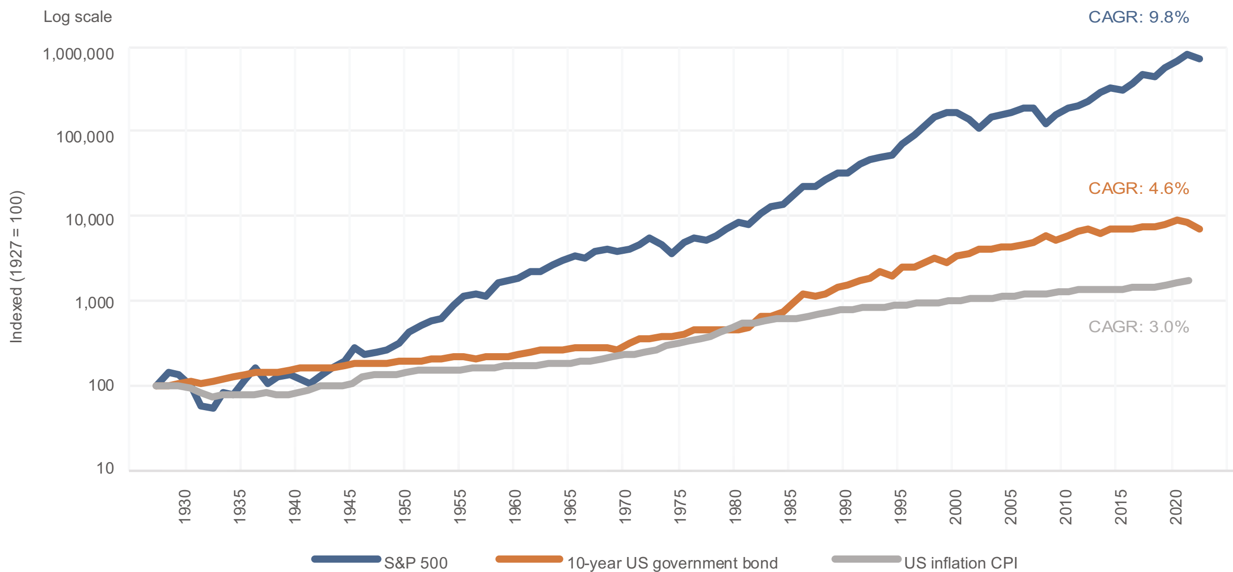
Over a long enough period, stocks perform much better than bonds. As figure 2 illustrates, on the next page, the average annual return on stocks (here represented by the S&P 500 index) was 9.8% p.a. over the past 95 years. Bonds, on the other hand, only returned 4.6%.

This chart makes it difficult to see how inflation would swindle equity investors, as Mr. Buffett put it. They have earned an inflation-adjusted return of 6.8% in the past 95 years, while bond investors have had to settle for 1.6%.

The 1970s were abysmal for stocks

However, Mr. Buffett's article was written in 1977, and his complaint concerns periods of extraordinarily high inflation. His argument goes something like this: the average return on equity (ROE) for stocks in the Dow Jones Industrials and Fortune 500 indices averaged 12% in the decades 1946-1955, 1956-1965, and 1966-1975. How-

Figure 2
Stocks have significantly outperformed bonds



Source: Aswath Damodaran (NYU Stern), officialdata.org, as of August 2023

"Stocks did poorly in nominal terms between 1966 and 1975, returning only 3.9% on average with an average inflation rate of 5.4%"

ever, inflation rose substantially in the latter decade, and the fact that ROE did not rise with it makes stocks "very similar to bonds".

Mr. Buffett argues that ROE should be considered an "equity coupon", i.e. a number that stays the same year after year, just like the annual coupons that most bonds pay.

In theory, one would expect ROE to rise when inflation surges. A spike in inflation should push revenue, costs, and profits higher. However, a company's balance sheet (especially one with long-duration assets) will grow only slowly, as old machinery and equipment will remain operational for years or even decades. The fact that ROE did not increase between 1966 and 1975 does indeed suggest that something was off.

That "something" showed in share prices too. Stocks did poorly in nominal terms between 1966 and 1975, returning only 3.9% on average. With that, they barely outperformed bonds, which yielded 3.7% per year. And with an average inflation rate of 5.4% between 1966 and 1975, real returns were negative. It is easy to understand why Mr. Buffett felt swindled.

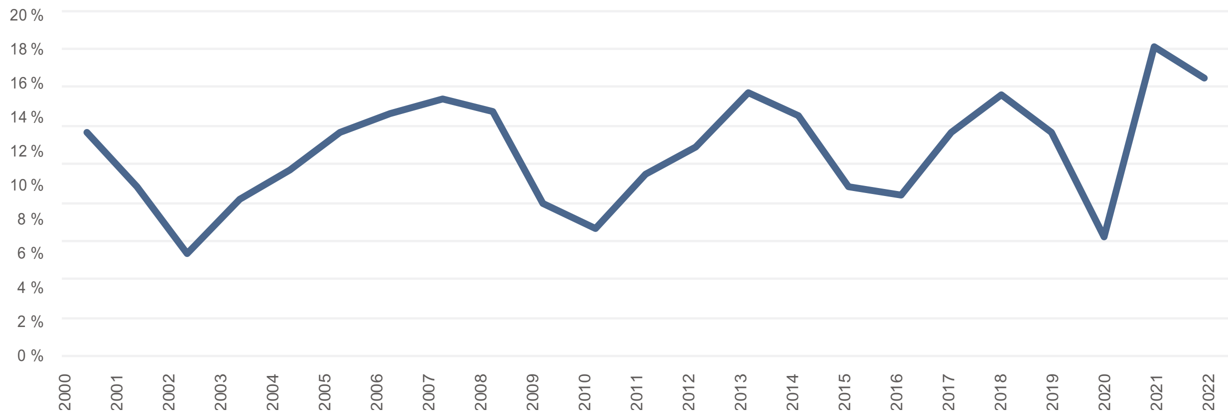
However, there may have been other culprits than inflation. ROE may have been kept at bay by weak economic activity; US GDP growth in 1970-1975 was 2.3%, compared to 4.5% in the 1960s and 4.2% in the 1950s. The fact that ROE remained at 12% despite the tougher economic times may indicate that stocks worked as a hedge against inflation, but that a decline in economic activity prevented it from increasing.

Additionally, inflation pushed interest rates much higher, which means higher borrowing costs for companies. Higher borrowing costs mean lower earnings and lower earnings mean lower ROE.

One could, of course, argue that high inflation was the original sinner in the 1970s – that it forced central bankers to raise interest rates and that higher interest rates

Figure 3

Return on equity, US companies



Source: Aswath Damodaran (NYU Stern), as of August 2023

“Corporate earnings have increased considerably in recent years and supports the notion that corporate earnings provide a hedge against inflation.”

caused a decline in economic activity. However, we think it is important to understand that inflation itself is not bad for equities. The potential consequences of it, on the other hand, are.

The 2020s – a new era

The recent bout of inflation suggests that the distinction between inflation and its consequences is important. In 2021-2022, inflation was at levels not seen since the 1970s and 1980s (see figure 1). However, unlike the 1970s, economic activity stayed strong. The rise in interest rates was also less dramatic than during the 1970s. This more favourable economic backdrop, coupled with the surge in inflation, allowed for a record-high average ROE in 2021, as seen by figure 3.

It is thus not a law of nature that ROE remains unchanged during a surge of inflation, as Mr. Buffett suggested when saying that ROE should be considered an “equity coupon”. Put differently, corporate earnings have increased considerably in recent years and are now well above the 2010-2019 trend. As illustrated by figure 4, the acceleration in earnings coincided with the increase in inflation. This supports the notion that corporate earnings correlate with nominal economic growth and thus provide a hedge against inflation.

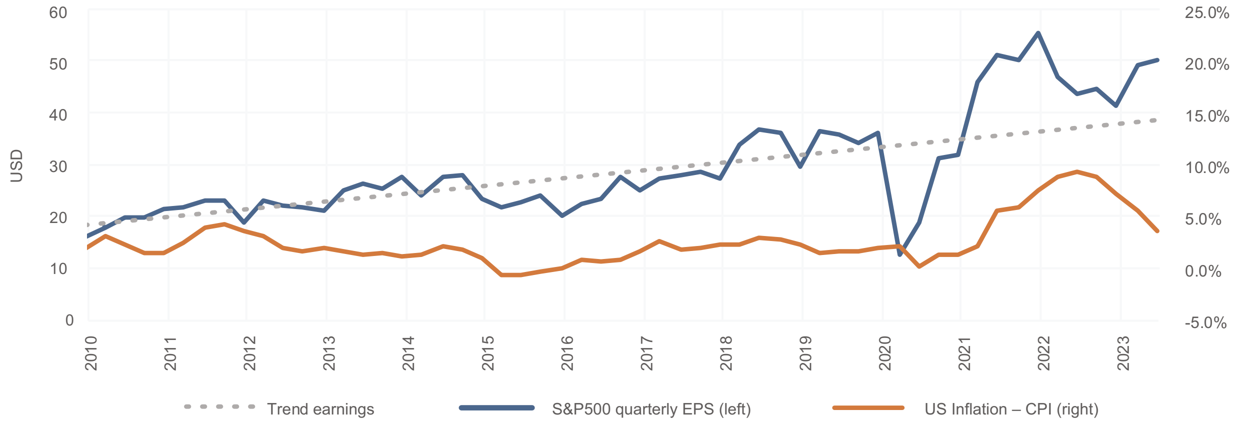
Finally, we note that while returns on stocks and bonds were similar between 1966 and 1975, the two asset classes do not always follow suit in periods of high inflation. As can be seen in figure 5, stocks returned +8.4% (annualized) from the end of 2020 to August 2023, while bonds lost 8.8%. During this period, inflation was 5.5% on average. The contrast between the two periods is stark.

Long-term equity investors need not worry about inflation

In summary, stocks are a natural hedge against inflation. In certain circumstances, it may not seem like it, but true long-term investors can take comfort in knowing that equity returns far exceed inflation (and bond returns) over the long haul. In the current inflation cycle, higher inflation seems to have lifted corporate earnings and supported equity returns since 2020.

Figure 4

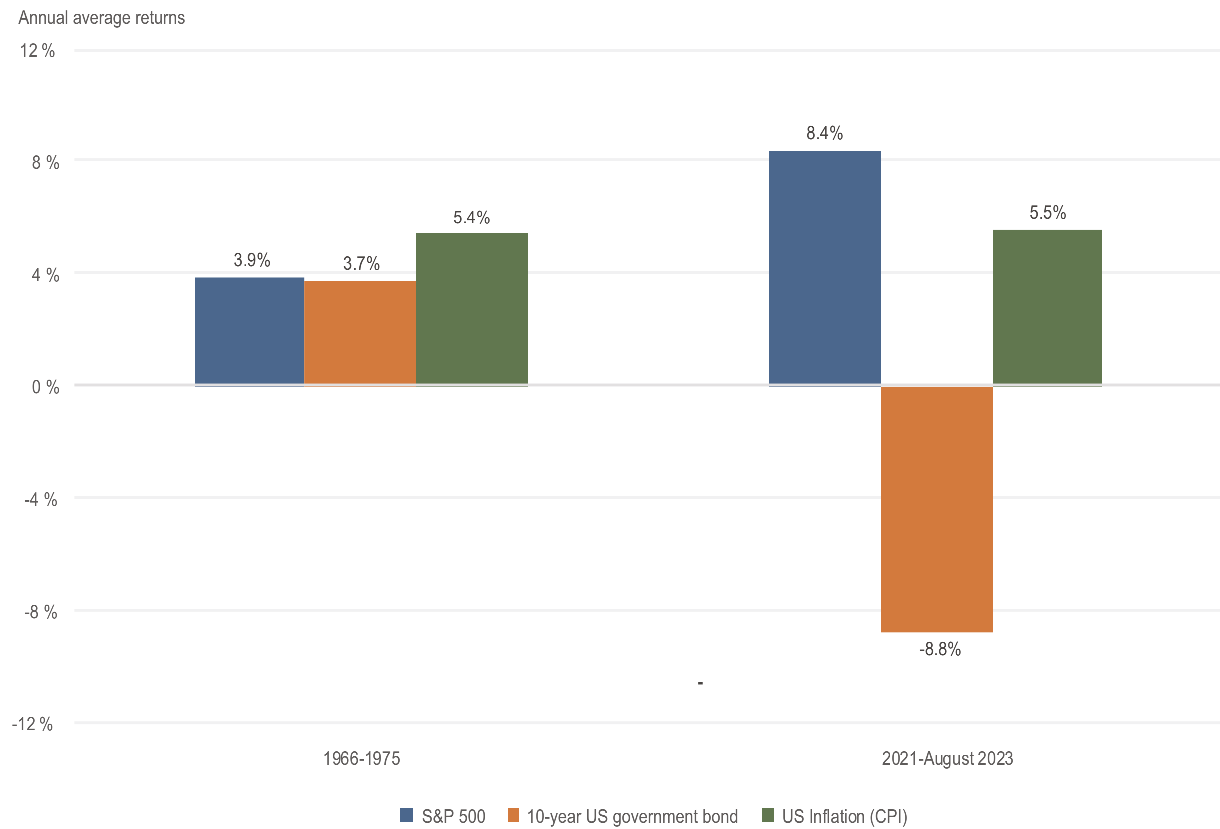
Recent spike in inflation seems to have impacted earnings positively



Source: Aswath Damodaran (NYU Stern), officialdata.org, C WorldWide Q3 2023

Figure 5

Equities have outperformed bonds significantly since 2021



Source: Aswath Damodaran (NYU Stern), officialdata.org, as of August 2023

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