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Inflation and the Value Investor

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The threat of inflation is making some investors cautious about equity markets. They wonder, "How will it affect my portfolio?" Benjamin Graham, widely regarded as the father of value investing, addressed this question in his book, *The Intelligent Investor*. He wrote, "There is no close time connection between inflationary (or deflationary) conditions and the movement of common-stock earnings and prices."[1]

Examining Graham's assertion, we looked at the relationship between inflation rates and *subsequent* stock market returns. Exhibit 1 shows that there was virtually no historical relationship between current year inflation (measured by the Consumer Price Index or "CPI") and stock market returns (measured by the S&P 500 Index) the following year between 1959 and 2009 in the United States. Underscoring the lack of a visible relationship in the table, the correlation between these variables was 0.05.

Exhibit 1: Annual U.S. CPI and Subsequent Year Total Return for the S&P 500 Index (1959-2009)

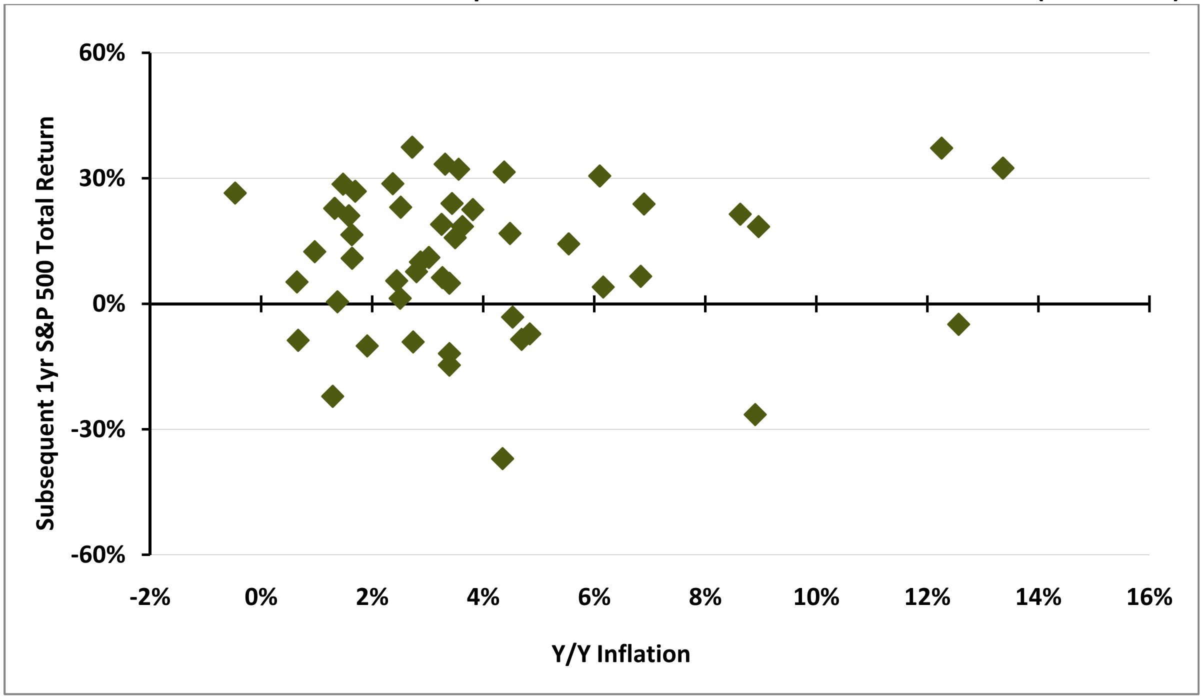
Year	U.S. CPI	Following Year S&P 500 Total Return	Year	U.S. CPI	Following Year S&P 500 Total Return
1959	1.4%	0.5%	1984	3.6%	32.2%
1960	1.7%	26.9%	1985	3.6%	18.5%
1961	0.7%	-8.7%	1986	0.6%	5.2%
1962	1.3%	22.8%	1987	4.5%	16.8%
1963	1.6%	16.5%	1988	4.4%	31.5%
1964	1.0%	12.5%	1989	4.5%	-3.2%
1965	1.9%	-10.1%	1990	6.1%	30.5%
1966	3.4%	24.0%	1991	2.8%	7.7%
1967	3.0%	11.1%	1992	2.9%	10.0%
1968	4.7%	-8.5%	1993	2.5%	1.3%
1969	6.2%	4.0%	1994	2.7%	37.4%
1970	5.5%	14.3%	1995	2.5%	23.1%
1971	3.3%	19.0%	1996	3.3%	33.4%
1972	3.4%	-14.7%	1997	1.5%	28.6%
1973	8.9%	-26.5%	1998	1.6%	21.0%
1974	12.3%	37.2%	1999	2.7%	-9.1%
1975	6.9%	23.8%	2000	3.4%	-11.9%
1976	4.8%	-7.2%	2001	1.3%	-22.1%
1977	6.8%	6.6%	2002	2.4%	28.7%
1978	9.0%	18.4%	2003	1.6%	10.9%
1979	13.4%	32.4%	2004	3.4%	4.9%
1980	12.6%	-4.9%	2005	3.5%	15.8%
1981	8.6%	21.4%	2006	2.4%	5.5%
1982	3.8%	22.5%	2007	4.3%	-37.0%
1983	3.3%	6.3%	2008	-0.5%	26.5%

Source: Ibbotson, as of 12/31/09
Past performance is not a guarantee of future results.

[1] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. 4th Revised Edition. New York: HarperCollins. 2003. Page 51.

Exhibit 2 also shows the lack of a clear relationship between inflation and stock market returns the following year, using a scatter plot diagram rather than a table.

Exhibit 2: Annual U.S. CPI and Subsequent Year Total Return for the S&P 500 Index (1959-2009)



Source: Ibbotson, as of 12/31/09
Past performance is not a guarantee of future results.

Despite the evidence showing virtually no relationship between these variables, Graham noted that investors who are more dependent upon income from their portfolios might want to adjust their allocation between stocks and bonds to accommodate inflation threats. He wrote that an investor "cannot afford to put all his funds" in bonds or stocks, exclusively.

At the same time, Graham acknowledged that stocks may not always be the best defense against inflation in the short term, but endorsed stocks as a viable asset class to help counter the erosive effects of inflation over the longer term: "There is no certainty that a stock component will insure adequately against such inflation, but it should carry more protection than the bond component."[2]

[2] Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel.* 4th Revised Edition. New York: HarperCollins. 2003. Pages 56-57.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

CPI is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food and transportation. The CPI is published monthly. Also called the cost of living index.

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