

### **Building Capital: A Crucial, and Difficult Activity**

For the great majority of individuals, businesses and non-profit organizations, few activities are more essential to their long-term well-being than *building capital*. And the process of doing that is often difficult.

In essence building capital is simple, involving just two components: saving money out of current income (sometimes including gifts) and investing it at remunerative returns to increase its long-term value. Saving enough to provide sufficient seed capital is frequently hard, requiring the *will* to do so. Investing it well can be hard, too, and it requires *skill*, especially in less favorable financial markets. Will plus skill is really the only effective formula.

And that's the problem that's moved front and center in the past dozen years – after a long, lush period from 1982 through 2007, when investment returns were so good that even dullards could build capital quite successfully. That quarter-century was blessed by strong economic growth, low inflation, stable business conditions, rising productivity, and successful innovation.

All these factors helped produce unusually strong corporate earnings growth and unprecedented increases in the valuations of stocks and bonds. The average price/earnings ratio on stocks soared from an historical low of 8 to a high of 19, driven by corporate earnings gains one-third faster than the historical average. Furthermore, normally sluggish bonds rose sharply in price as yields fell by 60% – from an unprecedented high of 15% on corporate issues in 1982 to a much more normal level of 6% in 2007.

Driven by a market tailwind of near-hurricane strength, building capital in that exceptional period was child's play. But even with the latest upswing in the stock market, that glorious era has passed away and now we're back to what at best is a more normal investment climate, and perhaps a difficult one in which earning decent investment returns will be a lot harder.

We all know the problems confronting investors today: slower economic growth; severely strained government and consumer finances all over the world; intensifying business competition (especially from surging Asian economic development); deteriorating ability of governments (many of which have become truly dysfunctional) to cope with their problems; slowing population growth; long stagnation of incomes; and the list goes on.

Added to these deterrents are less favorable bond and stock valuations today. Partly because of central banks' (the Federal Reserve and others) aggressive programs to drive interest rates down to help stimulate economic recovery, interest rates are the lowest in history, putting bond prices at all-time highs. So bonds of any maturity beyond a year or two present much greater risks of price declines than any advances at all, in the next few years at least. And stocks, after being historically undervalued briefly in 2010-2011, have now moved up a little above their long-term average valuation. They're not expensive now but they certainly are not cheap, as in the early 1980s.

Of course no one can predict the future with much accuracy. But considering all the factors I've cited, it does seem prudent to assume that investment returns for some time are *certain* to be much less favorable than in the golden years of 1982-2007 and *quite likely* to be somewhat lower than their



long-term averages. For stocks, we should probably scale back expectations for annual earnings per share growth, and the equivalent market appreciation that growth always produces, from 6% annually to 4-5%. Adding stocks' current dividend yields of only 2% on average (vs. 4% plus over the long-term past) would make likely future total returns from stocks just 6-7% (vs. the former 10%). Optimists can argue for 8%, but that certainly would be the maximum. (One of the most respected investment firms is projecting a 7.5% return from the most favored stock groups.)

For bonds, the likelihood of some price depreciation in coming years puts their prospective total returns several percent below the 7% they typically produced in the normal decade before 1978, when bond prices started to collapse as inflation exploded.

These possibilities produce the following potential investment returns from today forward for a simple portfolio invested 65% in stocks and 35% in bonds. (I've purposefully left out "alternative investments," where there's still a little *hope* for good returns, but whose *actual results* in recent years have generally been rather poor.)

**Assumed Investment Returns – 2013 Forward**

Portfolio: 65% Stocks, 35% Bonds

	<u>Stocks</u>	<u>Bonds</u>	<u>Combined</u>
Historical	10%	7%	9.0%
Future			
Optimistic	8%	6%	7.3%
Median	7	5.5	6.5
Pessimistic	6	5	5.7

Long-time readers know I'm a big believer in *doing the math* before making important investment decisions. And in few cases is that more necessary than when planning for future financial needs. Because of the decades-long time frame of such programs, even small deviations in the numbers change end-results a lot. This can best be demonstrated by making some simple, fact-based calculations.

For this purpose, I've calculated below how much capital *one dollar invested each year for forty years* would ultimately generate at the assumed rates of portfolio returns shown above – in comparison with the amount that would have been accumulated at the former higher rates of return prior to 2007, when investment conditions were more favorable. These figures are arresting, showing the much higher mountain investors have to climb now to meet their future financial needs.

**Cumulative Portfolio Values**

At 10-Year Intervals – \$1.00 Invested Each Year

<u>Annual Portfolio Returns</u>	<u>10 Years</u>	<u>20 Years</u>	<u>30 Years</u>	<u>40 Years</u>
Historical – 9.0%	\$17	\$56	\$149	\$368
Future Potential				
Optimistic – 7.3%	\$15	\$45	\$107	\$231
Median – 6.5	14	41	92	187
Pessimistic – 5.7	14	38	79	152



These figures indicate dramatically how much less money can be accumulated over a long period by seemingly not-huge differences in annual returns.

### Differential Results – Vs. 9% Portfolio Return

<u>Rate of Return</u>	<u>Amt. Return Below 9%</u>	<u>40-Year Value of Portfolio Vs. 9% Portfolio</u>
7.3%	- 19%	- 37%
6.5	- 28	- 49
5.7	- 37	- 59

This illustrates how crucial it is for investors to develop realistic expectations now for future rates of return. Otherwise, they could end up down the road with far too little in their personal capital accounts, their pension funds, endowment funds, etc. And if careful estimates indicate significant future shortfalls versus needs, there is only one solution to close any gap: SAVE MORE MONEY NOW and get it invested promptly.

This is a vital issue for all 401(k) and 403(b) defined contribution pension plans that now are the primary form of pension for the vast majority of today's workers. Within prescribed ranges, employers and their employees both decide what percent of salary to contribute to these plans every year. And there's a great temptation to hold down current contributions, to boost the employers' current profits and to enhance the amount of income employees have to spend immediately on personal needs and desires.

These pressures to hold down contributions – especially in our current society whose widespread attitude is “enjoy today and worry later about tomorrow” – have caused most 401(k)s and 403(b)s to be substantially underfunded today. And only a concerted effort by employers and plan sponsors to do the math and discuss it responsibly with employees will redress the massive shortfall that will result from the lower investment returns likely in the indeterminate future. If this effort is not made, many millions of employees are certain to live through their retirement years really in some degree of poverty. Many employees (and employers) now recognize this problem, but so far few have taken forceful action to overcome it, by saving lots more.

In contrast, alert institutional investors are already starting to confront the implications of lower investment returns. Endowment funds are beginning to reduce their annual spending rates, to leave more capital in their funds to produce satisfactory future fund growth that will protect the purchasing power of the assets. And some institutions are recognizing the need to raise more money to pump additional capital into their endowments. These steps are examples of the spending less and saving more that has become necessary.

In the traditional defined benefit pension fund area we are seeing divergent actions. Spurred by specific corporate regulations and their own recognition of the problem, *companies* have been greatly increasing the annual contributions to their funds. But at the same time most *public pension funds* (states and municipalities), which don't have stringent regulation and are overseen by politicians who don't like to face fiscal realities, are trying to muddle through their problems of huge pension funding inadequacies. Most have not retreated from their excessively high rates of assumed future investment returns (typically 8 - 8.5%). Nor have many increased their annual pension contributions, although a few have borrowed money to do so – just creating new debt to pay down the debt they owe their pension funds. This shell game fools nobody.



Also many public pension funds have taken a step that's a real no-no, to meet the problem of lower investment returns: using higher-risk investments that offer some little *hope* of, but no *assurance* of, greater investment returns – namely hedge funds and private equity funds. Many big state pension funds have been pouring huge amounts of money into hedge funds recently. It's true that in the past many of these funds produced superior returns. But that was long ago. Since the hedge fund sector grew to a large size in the early 2000s, collectively these funds have *underperformed* the plain, old S&P 500 index of the stock market – in nine of the last ten years, by an average of 4.4% annually for the decade. (Ten times – 4.4% = - 44%!) So public pension funds seem to be chasing a will-o-the-wisp here, and adding risk to their portfolios in the process. Dodging reality rarely makes sense.

Individuals have two large capital accumulation needs for their families: coping with huge, and still-rising college tuitions, and providing for their retirement. Those needs have shorter time frames than institutions' virtually perpetual needs and they have to be financed by income streams that for most people typically start low at younger ages and increase over time, instead of being level as institutions' cash flow tends to be. Meeting these personal needs is a critical problem today. A recent study by the Urban Institute shows that adults up to age 40 have now accrued *less* wealth than their parents did at the same age, even though the cost of living has risen considerably and the average wealth of all Americans has doubled. Obviously this is the result of adverse economic conditions and huge increases in students' college tuition loans, which prevent them from saving much, if any, money in their early working years.

Further, individuals have to cope with a daunting mathematical fact: the time value of money. The longer a dollar stays invested, the more it grows in value. So early contributions to a college tuition fund or personal pension fund, 401(k) or otherwise, will produce *much more* money than later contributions. The math is compelling, as shown by this tabulation of dollar accumulations over 40 years for portfolios at a median possible future investment return, versus the past historical rate.

**Value In Year 40 of \$1.00 Invested in Selected Years**

<u>Annual Return</u>	<u>Year Invested</u>	<u>Value in Year 40</u>	
9%	Year 1	\$31.40	
	10	13.27	
	20	5.60	
	30	2.37	
			<u>Shortfall Vs. 9% Return</u>
6.5%	Year 1	\$12.42	- 60%
	10	6.61	- 50
	20	3.52	- 37
	30	1.88	- 21

The huge advantage of long-term investments versus short-term ones means that *half or more of all the ending values* in the 40-year periods shown on the table on the bottom of page 2 are produced by the annual contributions in just the *first decade*. So, hard as it may be with lower income in their younger years, individuals must discipline themselves to make substantial early contributions to their capital funds. This is especially true when likely future investment returns are not high, as shown clearly in the table above.



Facing reality is never easy, but it has to be done. And today's reality is that, being sensible, we have to plan for somewhat lower investment returns ahead than in the past, maybe not as low as I've shown, but certainly lower. And they can only be coped with by saving more from current consumption – on the part of individuals, institutions, and businesses – to build adequate capital for the future. Really we have no choice but to adjust to the vagaries of the investment climate, just as sailors must adjust to the vagaries of the wind. As author-sailor William Arthur Ward said, "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

### End Note

The discussion in this letter concerns the *building* of capital in an era of possibly lower investment returns. Of course, less favorable returns will also affect the *maintenance* of current capital in terms of its purchasing power. In that respect, the negative impact of reduced returns will be much less than in building portfolios, but enough to consider seriously.

If corporate earnings growth slows from the historical 6% annually to 4-5% – and stocks continue to advance in line with earnings growth – theoretically a portfolio invested 65% in stocks would *appreciate* (ignoring dividend and interest income) at 2.6-3.3% annually, not the old 4%. That's right at the 3% long-term rate of inflation, leaving little margin for any forecasting errors to sustain purchasing power. So to be safe, prudent investors should consider adding a little cash to their present capital funds each year.

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