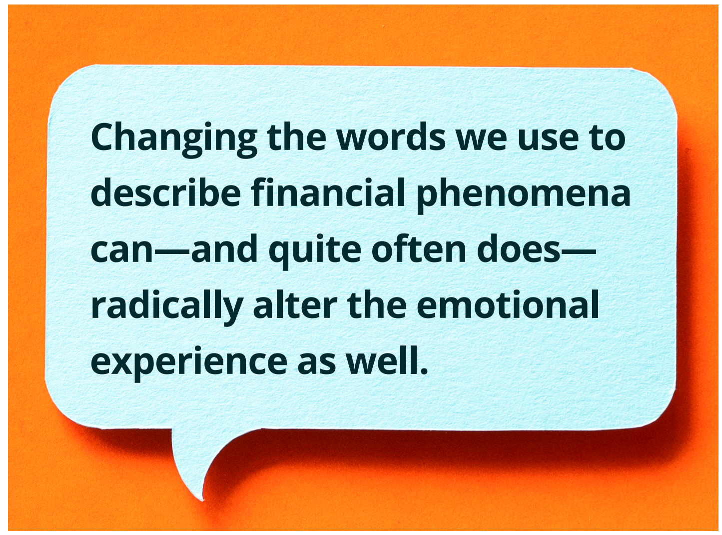
Client's Corner

Words Matter



IMAGINE THAT YOU AND I ARE CHATTING CASUALLY ABOUT investing. And in response to a question from you, I mention that my core strategy is "to own a basket of shares in 500 of the largest, most soundly financed, most profitable and most innovative companies headquartered in America."

By all means, correct me if I'm wrong, but I think you might initially be somewhat intrigued by this formulation, and think that it sounds interesting, rational and perhaps even comfortable.

Now suppose that I had answered your very same question by saying, ***"I invest in the stock market."*** I believe your instinctive reaction would most probably be along the lines of "Gee, that sounds really risky, especially for a guy who is—to put it kindly—no spring chicken."

In the first formulation, I was alluding to ownership of an index fund that replicates as nearly as possible the Standard & Poor's 500-Stock Index. At year-end 2022, the total market capitalization of those 500 companies was $33.8 trillion. That was around 83% of the total market capitalization of ***all*** U.S. publicly held stocks.

In other words, the two hypothetical responses cited above are, for all intents and purposes, the same answer. By owning fractional pieces of its 500 largest and most stable component companies, I'd be investing in substantially the whole stock market.

Full disclosure: I do not, in fact, personally own an S&P 500 index fund. I'm just using it to illustrate a point. That point, as I have good hope that you've already grasped, is that ***changing the words we use to describe financial phenomena can—and quite often does—radically alter the emotional experience as well.***

Let me offer another example. The culture describes equity investing as "aggressive" and bond investing as "conservative." But by owning bonds—especially as a core long-term strategy—what is the investor trying to conserve? The culture answers, "He's trying to conserve his money, of course." But what if that's not quite true? And what if it simply proceeds from a misuse of words?

Granted, the bond investor is clearly trying to conserve the number of units of the currency he has. But he's equating "money" with "currency." And the longer one's investing time horizon, the less compelling that equivalency becomes. Indeed, I would suggest that if you retire with a million dollars, and succeed in preserving that million dollars throughout a 30-year two-person retirement, then at trendline hundred-year 3% inflation you'll have lost about 60% of your money—***if, as I do, you define "money" as "purchasing power."***

What that means, in plain English, is this: Assume your "safe" million paper dollars produced the same "safe" withdrawal capability ($40,000? $50,000?) for the whole 30 years. Assume trendline (hundred-year average) inflation of three percent a year throughout. Now realize that at that inflation rate, your cost of living over the three decades will have gone up just shy of two and a half times—possibly and perhaps even probably overwhelming your "safe" withdrawals. In what sense does this strike you as "conservative"?

On the other hand, let's say you had placed your million dollars in the "aggressive" "stock market" 30 years ago. Again, let's use the S&P 500 as our proxy, and measure from the end of 1992 to the end of 2022. Let's say further that you had elected to live on your dividends. Your million dollars would have become a little over $8 million (assuming taxes were paid from another source), and your dividend income would have more than quintupled, ***while the CPI cost of living barely doubled.***

What should the genuinely conservative investor be trying to conserve for the long run? Why, his money, of course. Ah, but how have we decided to define money for the long run? Exactly: as purchasing power. Following this line of reasoning, those investments might be deemed most conservative which have historically provided the greatest margin of long-term total return ***in excess of inflation.*** That's exactly what mainstream U.S. equities have done ***in the long run.***

And for many if not most of us, retirement is going to be the longest run of our lives.

Sources: Total market cap of the S&P 500: Standard & Poor's, Wikipedia. Total market cap of the entire U.S. market: Siblis Research. S&P values and dividend data: NYU Stern School. CPI inflation: Bureau of Labor Statistics, inflationdata.com.