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INVESTING FOR "SAFETY"

At the outset, let us concede that there never has been, and probably never will be, a perfectly "safe" investment. When discussing the dimension of an investment's safety, what we are concerned with is its relative "degree of risk" as compared to that of alternative investments.

This is not the biggest semantic difficulty one has in addressing the question of safety in an investment, however. Many investors who think that they want one kind of safety do, in fact, prefer another. In its traditional sense, "safety" means the "preservation of principal." After giving the matter some consideration, however, most conclude that what they really prefer to preserve, even more than "principal," is "purchasing power."

Let us imagine that there are two ideal investments into which we might put our money. One investment, which we shall call Instrument #1, guarantees us that we may redeem our original investment, at any time, dollar-for-dollar - no more, no less. The second investment, Instrument #2, on the other hand, does not guarantee us exactly the same number of dollars back, but it does guarantee us our purchasing power. In other words, it guarantees us, at any time, just as many dollars as it will take to purchase the same amount of goods and services as our original investment would have purchased in the first place - no more, no less. Now let us examine the merits of each investment, given two different economic scenarios:

DEFLATION

Let us first assume a period of price deflation such as we had in the Great Depression of the 1930s. For the sake of simplicity, let us assume that the consumer price index, over a ten-year span of time, declines by 50%. If, at the beginning of the period, we had $1,000, and bread was $1 per loaf, we could have purchased 1,000 loaves of bread. At the end of the period, bread is 50 cents a loaf. If we had put $1,000 into Instrument #1 at the beginning of the period, we still would have exactly $1,000 at the end of the period; but, while we could have purchased 1,000 loaves of bread at the beginning, we can buy 2,000 loaves at the end. With Instrument #2, the dollar value of our investment has diminished to $500, but we are still able to purchase 1,000 loaves of bread at the end of the ten-year period, as we had been able to at the beginning. In

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short, Instrument #1 has been a profitable investment, given the fact that we had deflation. Instrument #2 did not make a profit, but it was not a bad investment either, because it provided the perfect preservation of purchasing power that was expected of it.

INFLATION

Now let us assume that we have a ten-year period of inflation, during which the consumer price index doubles, and so bread goes to $2 per loaf. At the end of the ten-year period, though the $1,000 we have invested in Instrument #1 is still worth $1,000, that $1,000 will purchase only 500 loaves of bread instead of its original 1,000. Instrument #2, on the other hand, by definition, has grown in value to $2,000, and so we can still buy our 1,000 loaves of bread. Clearly, in this inflationary period, Instrument #2 has provided greater safety of purchasing power than Instrument #1.

SAFETY OF PURCHASING POWER VERSUS SAFETY OF PRINCIPAL

Given the observation that, though "man lives not upon bread alone," our material well-being is of vital concern to most of us, it seems manifest that safety of "purchasing power" should probably be a higher priority investment objective for the average investor than safety of "principal" alone. Contrary to conventional wisdom, it can even be argued that the investor who would put his money in Instrument #1 is more of a risk-taker than he who would put his money into Instrument #2. The former is gambling that there will be no inflation to cause him a loss of purchasing power, but rather that there may be deflation, in which case he will make a purchasing power profit. On the other hand, the investor who would put his money in Instrument #2 subjects himself to no purchasing power risk, whether the ten-year period is inflationary or deflationary.

As we said at the outset, there is no perfect Instrument #1 and no perfect Instrument #2. Historically, however, fixed income securities (bonds, CDs, etc.) have been more akin to Instrument #1, and equities (common stock, real estate, etc.) have been more akin to Instrument #2. The purpose of the foregoing exercise is, first, to be sure that the reader, when he seeks "safety" in his investments, is cognizant of these two disparate definitions of the word -

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"preservation of principal" and "preservation of purchasing power" - and knows, in his own mind, the relative importance of each to himself.

THE LESSONS OF HISTORY

In trying to make the judgment of how to allocate one's priorities between the two types of "safety," a reflection on the experiences of history seems in order. One purpose in owning fixed income securities is, of course, to reduce the chance of money loss that one might otherwise experience in the ownership of common stocks. It is useful to note, in this regard, that the average annual rate of total return on common stocks in general over the past half century has been over twice the average annual total return on bonds.[1] In other words, though there may have been many individual exceptions, it would appear, from the aggregate data, that the average common stock investor, over the period, was actually over two times better cushioned even against loss of principal than was the average bond investor.

With respect to the effects of inflation, in terms of its value fifty years ago, the dollar is worth just 15 cents today.[2] In other words, a half century of investing in fixed income securities has resulted in an 85% loss of purchasing power.

In conclusion, it would appear that, in modern times, the "preservation of purchasing power" may deserve an even higher priority in one's financial planning than "preservation of principal" alone.

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1998

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[1] According to Ibbotson Associates' 1999 Yearbook, over the fifty-year period, 1949-1998, the average annual compound total returns on various asset classes were as follows: long-term U. S. Government bonds, 5.9% per year; long-term corporate bonds, 6.2%; large company stocks, 13.6%, and small company stocks, 14.8%.

[2] The annual compound rate of inflation, as measured by the Consumer Price Index, averaged 3.9% per year over the 1949-1998 period.

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