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The Tradeoff:
Preserving Capital or Preserving Purchasing Power

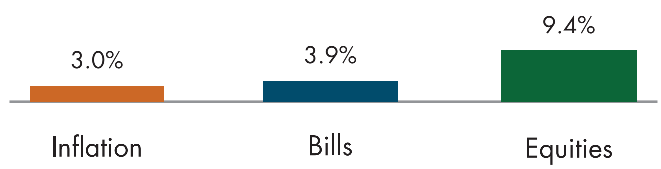
Investing, by definition, involves taking risk, but investors often have different views about what constitutes risk. Some people look at risk as short-term price volatility. They have difficulty stomaching the daily ups and downs associated with investing in stocks, because declining prices are often accompanied by predominantly negative headlines. To avoid major fluctuations in their portfolio value, they favor short-term CDs, money market funds, or Treasury bills. Their goal is to *preserve capital*.

Other investors define risk as the loss of *purchasing power*, or real wealth. They have long-term financial obligations, such as spending during their retirement years, and their primary goal is building wealth to meet those future expenses. They recognize that while the cumulative effects of inflation are sometimes glacially slow, or even undetectable in real time, inflation can be the silent killer of a financial plan. They are willing to live with the higher volatility of stocks and other growth-oriented assets to preserve their future lifestyle.

In reality, most investors want to manage both types of risk, and understanding the tradeoffs between preserving capital and purchasing power can help them approach the task. To illustrate, let's consider over a century of performance data in the U.S. financial markets.

The first graph, titled "Preservation of Purchasing Power," shows that U.S. equities have delivered a much higher nominal (unadjusted for inflation) annualized return than inflation and T bills. This graph clearly demonstrates that equities have outperformed stable-value assets over the long term.

Preservation of Purchasing Power, 1900–2010[1]
Nominal Annualized Returns



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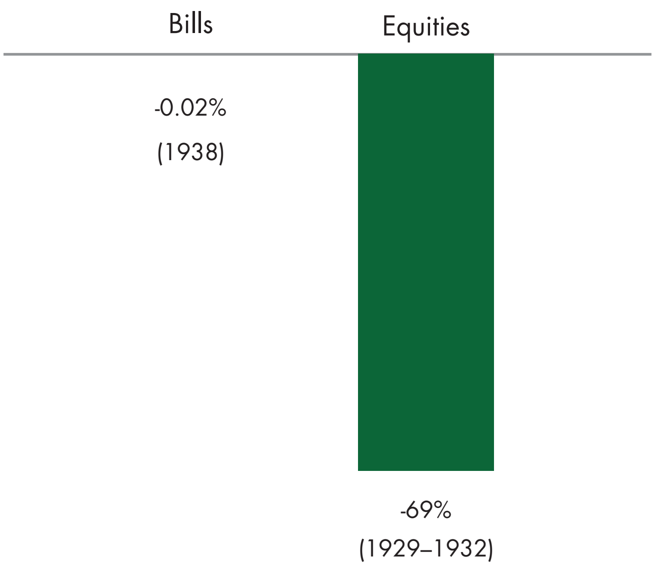
Preservation of Capital, 1900–2010[1]
Worst-Performing Periods
Nominal Total Returns

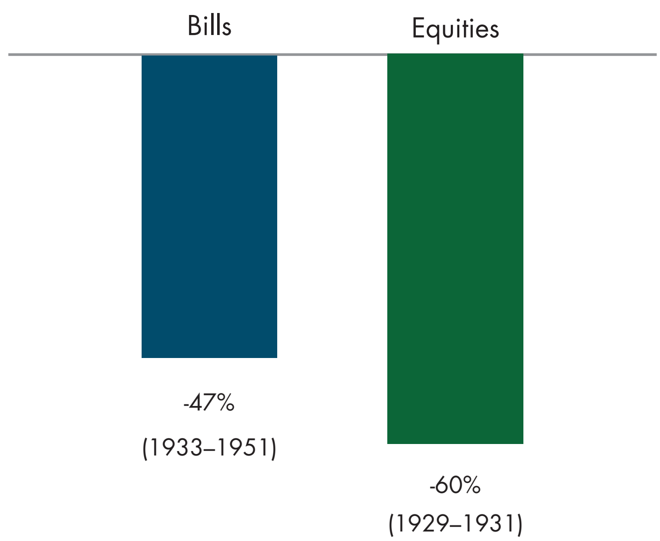


However, as shown in the "Preservation of Capital" graph, equity investors had to bear periods of high volatility. During the U.S. equity market's worst period (1929–1932), equities lost 69% of their value. By contrast, the worst period for U.S. bills was in 1938, when bills lost 0.02% in nominal terms. If an investor cares most about preserving capital, bills would appear more stable than stocks.

But the picture is quite different after adjusting for inflation.

The "Risk-Free or Risky?" graph at top right shows the worst performing periods for bills and equities in real terms, after adjusting for annual inflation. U.S. equities weathered a difficult period from 1929 to 1931, losing 60% in real value after adjusting for inflation. More surprising is the 47% real loss of value for risk-free bills between 1933 and 1951. So, after adjusting for inflation, the worst period of performance for bills is also substantial. The lower return potential of bills casts doubt on their ability to preserve real wealth.

Risk-Free or Risky?, 1900–2010[1]
Worst-Performing Periods
Real Total Returns



As shown in "Recovery Times" chart, below, the worst period for equities was much shorter than the worst period for U.S. bills (3 years vs. 19 years), and equities

Recovery Times, Real Total Returns, 1900–2010[1]

	Bills	Equities
Peak to Trough:	19 Years	3 Years
Recovery:	48 Years	4 Years

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recovered much faster (4 years vs. 48 years) due to their historically higher return.

Investors who want to preserve purchasing power may feel the risk of equities in real time. However, equities also have a good historical chance of outpacing inflation. In contrast, investors who try to preserve long-term capital by holding cash may pay a heavy price as inflation quietly erodes their real wealth over time.

In reality, investors do not need to choose exclusively between the risks of short-term volatility and long-term loss of purchasing power. Diversifying among a variety of market areas, including cash, stocks, bonds and real estate securities is a better alternative. Global balanced investing provides the most proven means of lowering the variability of short-term performance and generating attractive returns over the long-term.

Disclosures

Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.

Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

Nothing herein constitutes (i) legal, accounting or tax advice, (ii) a recommendation to buy, sell or hold a security or (iii) advice as to whether any investment strategy is suitable for a particular investor.

Sources

1. Dimensional Funds Advisors, Dimson Marsh Staunton (DMS) Global Returns Database.

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