RESEARCH CAPITAL CORPORATION

The Elephant In The Living Room

The greatest risk is right in front of us all.

Those new to investing are rightly concerned with the issue of risk. Risk in investing is real, but like many issues in life, can be managed. Many people, though, are so transfixed by the possibility of losing money that they adopt a strategy that guarantees that they will lose money, sometimes a lot of it.

A little slice of history from the lives of most baby boomers will show you the elephant that everyone knows is there, but that many refuse to acknowledge, inflation.

By the 1950s, the decade when most baby boomers were born, the penny had become small change, but it wasn't useless. A child could buy a nice candy, and a parent could buy 20 minutes of parking meter time in downtown Toronto. For three cents you could send a first-class letter anywhere in the local area; for another penny, you could send that letter anywhere in the country.

In the early 2000s a first-class stamp was 52¢, at 17 times the cost of a 1953 first-class stamp, a reminder of inflation's relentless destruction of your purchasing power. From 1926 to 2000, US inflation (which is close enough to Canadian inflation to validate the example) ran an average of 3.1% a year. Compounded at that rate, inflation halved the purchasing power of a dollar every 23 years. To express that another way, if you had put a $100 bill in your piggy bank 23 years ago, it would still be $100, but it would only buy goods and services priced at $50 when you put it away.

Let's now set that fact – a dollar loses half of its purchasing power every 23 years – beside the standard retirement saving advice – "buy something that's safe", "buy something that's guaranteed".

It's sensible advice on the face of it, except that 'safe' investment instruments such as GICs and savings bonds usually pay only a percentage point or two above existing inflation. After you've paid the required income tax, the combination of inflation and tax means you're on the same downward treadmill as the $100 bill in the piggy bank. Every year, year after year.

In contrast, look at Power Corp. of Canada. In the five years from 1999 to 2004, Power Corp.'s dividend rose from 49¢ to $1.15 a share, a yearly average compounded growth rate of 18.6% – six times the average inflation rate.

"That's all very well," you may reply, "because you've shown us what happens when you pick a winner. What happens if you pick a loser that goes down 18.6%? Or becomes worthless?"

To get an answer to that, read my next article “The Hot Pick Versus The Balanced Portfolio”.

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