Inflation and reported returns

Letters: 1979, 1980, 1981 · Difficulty: Advanced

Summary

In the late 1970s and early 1980s, inflation ran above 10%. Financial statements built on **historical cost** overstated real earnings, because depreciation and inventory costs were based on old, lower prices. Buffett explains why a business earning a respectable return on equity could still give its owners little or no real return.

1979 letter

Now such an outcome seems less certain. For the inflation rate, coupled with individual tax rates, will be the ultimate determinant as to whether our internal operating performance produces successful investment results - i.e., a reasonable gain in purchasing power from funds committed - for you as shareholders. Just as the original 3% savings bond, a 5% passbook savings account or an 8% U.S. Treasury Note have, in turn, been transformed by inflation into financial instruments that chew up, rather than enhance, purchasing power over their investment lives, a business earning 20% on capital can produce a negative real return for its owners under inflationary conditions not much more severe than presently prevail.

If we should continue to achieve a 20% compounded gain - not an easy or certain result by any means - and this gain is translated into a corresponding increase in the market value of Berkshire Hathaway stock as it has been over the last fifteen years, your after-tax purchasing power gain is likely to be very close to zero at a 14% inflation rate. Most of the remaining six percentage points will go for income tax any time you wish to convert your twenty percentage points of nominal annual gain into cash. That combination - the inflation rate plus the percentage of capital that must be paid by the owner to transfer into his own pocket the annual earnings achieved by the business (i.e., ordinary income tax on dividends and capital gains tax on retained earnings) - can be thought of as an investor's misery index. When this index exceeds the rate of return earned on equity by the business, the investor's purchasing power (real capital) shrinks even though he consumes nothing at all.

We have no corporate solution to this problem; high inflation rates will not help us earn higher rates of return on equity. One friendly but sharp-eyed commentator on Berkshire has pointed out that our book value at the end of 1964 would have bought about one-half ounce of gold and, fifteen years later, after we have plowed back all earnings along with much blood, sweat and tears, the book value produced will buy about the same half ounce.

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Actually, that very accounting convention may have contributed in a major way to the losses; had management been forced to recognize market values, its attention might have been focused much earlier on the dangers of a very long-term bond contract. Ironically, many insurance companies have decided that a one-year auto policy is inappropriate during a time of inflation, and six-month policies have been brought in as replacements. How, say many of the insurance managers, can we be expected to look forward twelve months and estimate such imponderables as hospital costs, auto parts prices, etc.? But, having decided that one year is too long a period for which to set a fixed price for insurance in an inflationary world, they then have turned around, taken the proceeds from the sale of that six-month policy, and sold the money at a fixed price for thirty or forty years. The very long-term bond contract has been the last major fixed price contract of extended duration still regularly initiated in an inflation-ridden world. The buyer of money to be used between 1980 and 2020 has been able to obtain a firm price now for each year of its use while the buyer of auto insurance, medical services, newsprint, office space - or just about any other product or service - would be greeted with laughter if he were to request a firm price now to apply through 1985.

1980 letter

Within the corporate world such a result is quite rare; in our case it is likely to be recurring. Our own analysis of earnings reality differs somewhat from generally accepted accounting principles, particularly when those principles must be applied in a world of high and uncertain rates of inflation. (But it's much easier to criticize than to improve such accounting rules.

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You may feel richer, but you won't eat richer. High rates of inflation create a tax on capital that makes much corporate investment unwise - at least if measured by the criterion of a positive real investment return to owners. This "hurdle rate" the return on equity that must be achieved by a corporation in order to produce any real return for its individual owners - has increased dramatically in recent years. The average tax-paying investor is now running up a down escalator whose pace has accelerated to the point where his upward progress is nil.

For example, in a world of 12% inflation a business earning 20% on equity (which very few manage consistently to do) and distributing it all to individuals in the 50% bracket is chewing up their real capital, not enhancing it. (Half of the 20% will go for income tax; the remaining 10% leaves the owners of the business with only 98% of the purchasing power they possessed at the start of the year - even though they have not spent a penny of their "earnings"). The investors in this bracket would actually be better off with a combination of stable prices and corporate earnings on equity capital of only a few per cent. Explicit income taxes alone, unaccompanied by any implicit inflation tax, never can turn a positive corporate return into a negative owner return.

(Even if there were 90% personal income tax rates on both dividends and capital gains, some real income would be left for the owner at a zero inflation rate.) But the inflation tax is not limited by reported income. Inflation rates not far from those recently experienced can turn the level of positive returns achieved by a majority of corporations into negative returns for all owners, including those not required to pay explicit taxes. (For example, if inflation reached 16%, owners of the 60% plus of corporate America earning less than this rate of return would be realizing a negative real return - even if income taxes on dividends and capital gains were eliminated.) Of course, the two forms of taxation co-exist and interact since explicit taxes are levied on nominal, not real, income. Thus you pay income taxes on what would be deficits if returns to stockholders were measured in constant dollars.

At present inflation rates, we believe individual owners in medium or high tax brackets (as distinguished from tax-free entities such as pension funds, eleemosynary institutions, etc.) should expect no real long-term return from the average American corporation, even though these individuals reinvest the entire after-tax proceeds from all dividends they receive. The average return on equity of corporations is fully offset by the combination of the implicit tax on capital levied by inflation and the explicit taxes levied both on dividends and gains in value produced by retained earnings. As we said last year, Berkshire has no corporate solution to the problem. (We'll say it again next year, too.) Inflation does not improve our return on equity.

Indexing is the insulation that all seek against inflation. But the great bulk (although there are important exceptions) of corporate capital is not even partially indexed.

1981 letter

Two major categories stand out. The first involves companies that, through design or accident, have purchased only businesses that are particularly well adapted to an inflationary environment. Such favored business must have two characteristics: (1) an ability to increase prices rather easily (even when product demand is flat and capacity is not fully utilized) without fear of significant loss of either market share or unit volume, and (2) an ability to accommodate large dollar volume increases in business (often produced more by inflation than by real growth) with only minor additional investment of capital. Managers of ordinary ability, focusing solely on acquisition possibilities meeting these tests, have achieved excellent results in recent decades.

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Such market variations will not always be on the pleasant side. In past reports we have explained how inflation has caused our apparently satisfactory long-term corporate performance to be illusory as a measure of true investment results for our owners. We applaud the efforts of Federal Reserve Chairman Volcker and note the currently more moderate increases in various price indices. Nevertheless, our views regarding long-term inflationary trends are as negative as ever.

Like virginity, a stable price level seems capable of maintenance, but not of restoration. Despite the overriding importance of inflation in the investment equation, we will not punish you further with another full recital of our views;

inflation itself will be punishment enough. (Copies of previous discussions are available for masochists.) But, because of the unrelenting destruction of currency values, our corporate efforts will continue to do a much better job of filling your wallet than of filling your stomach.

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Unhappily, most companies can do little but hope that the bar will be lowered significantly; there are few industries in which the prospects seem bright for substantial gains in return on equity. Inflationary experience and expectations will be major (but not the only) factors affecting the height of the crossbar in future years. If the causes of long-term inflation can be tempered, passive returns are likely to fall and the intrinsic position of American equity capital should significantly improve. Many businesses that now must be classified as economically 'bad' would be restored to the 'good' category under such circumstances.

A further, particularly ironic, punishment is inflicted by an inflationary environment upon the owners of the 'bad' business. To continue operating in its present mode, such a lowreturn business usually must retain much of its earnings - no matter what penalty such a policy produces for shareholders.

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However, the non-earning third servant is not only chastised - 'wicked and slothful' - but also is required to redirect all of his capital to the top performer. Matthew 25: 14-30) But inflation takes us through the looking glass into the upside-down world of Alice in Wonderland. When prices continuously rise, the 'bad' business must retain every nickel that it can.

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If it wishes to continue operating in the future as it has in the past - and most entities, including businesses, do - it simply has no choice. For inflation acts as a gigantic corporate tapeworm. That tapeworm preemptively consumes its requisite daily diet of investment dollars regardless of the health of the host organism.

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Under present conditions, a business earning 8% or 10% on equity often has no leftovers for expansion, debt reduction or 'real' dividends. The tapeworm of inflation simply cleans the plate. (The low-return company's inability to pay dividends, understandably, is often disguised.

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Note in the table below the year-over-year gain in industrywide premiums written and the impact that it has on the current and following year's level of underwriting profitability.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1979, 1980, 1981 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.