GUEST VIEWPOINT
A COLUMN

The Infallible Forecast

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There seems to be no end to the desire to uncover what the future holds, and thereby render a prediction about the market's future course. Yet, before the 1987 Unpleasantness, respected forecasters were predicting the Dow would reach 3600. Afterward, some predicted a further fall to 1500. And now, in the last month, forecasts have ranged from 400-5000. Surely, experience has shown such efforts to be fruitless.

This perpetual return to the crystal ball in search of the Infallible Forecast, in spite of its poor track record, stems largely from a misunderstanding about the stock market and the capital creation process. Such predictions interest those who view the stock market as the creator or eliminator of the return on their capital. For them, a correct forecast results in a good trade, which increases their capital, while a wrong forecast results in a loss.

In constrast, anyone committed to long-term business ownership knows that the stock market does not create capital--it merely reflects the value of the capital invested in the underlying businesses. Over time, as businesses earn profits and reinvest a portion for growth, the shareholders' capital grows. This growth through the reinvestment process is the true creator of capital, and is ultimately reflected in the stock's price.

Thus, the long-term investor should look for companies that are superior at earning and reinvesting capital. With confidence in one's business's capital creation ability, an investor can wait patiently as his/her capital builds, and need not worry about the current forecasts.

Now, just as the stock market does not create capital for the shareholders, it likewise does not eliminate it. For this, investors must worry about two other threats: Inflation and Insolvency.

Inflation eliminates capital permanently by eroding its real value. Anyone who structures a portfolio without taking into account the role of inflation in the business's ability to create capital has not thought wisely about the threats he/she faces. The investor is building a house without a roof. One need not know when rain will come to know that protection against it is vital to a home's survival. Likewise, protection against inflation is vital to the survival of capital.

A shareholder's best protection against inflation is his/her business's ability to earn a high return on capital. For example, if a business only earns 7 percent on its capital, it will end up with a negative real return whenever inflation moves above 7 percent. Here, the capital creation process reverses--inflation is destroying capital faster than the business is creating it. This erosion of capital would surely be reflected in the market's price. Would it not be better to own a business that earns say, 15 percent, since it would continue to increase one's capital in real terms?

The other threat to capital is Insolvency--which ends the going concern's ability to create and reinvest capital for its owners. While the post-war period has been fairly benign with respect to the risk of insolvency, shareholders of the 1930's whose stock certificates ended up as mere collector's items can attest to the permanency of capital elimination from insolvency. The recipe for insolvency is unstable earnings and high debt. Therefore, the wise investor restricts his/her investments to companies with stable earnings and low debt.

Thus, investors who build in protection against inflation and insolvency--by owning the right kind of businesses--remove the primary threats to their capital, and can end their search for the Infallible Forecast.☐

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