LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"Every generation laughs at the old fashions, but follows religiously the new."
–Henry David Thoreau

The total return on financial assets reflects the combination of capital appreciation and current income. The latter includes interest on bonds and dividends from equities. Recent experience has led investors to believe that capital appreciation, not income, is the larger component of total return. Over extended periods of time, however, more than half of the total return from financial assets has been the income portion.

For the past thirty years, stocks have yielded less than bonds–contrary to the experience of the previous thirty years. From the early 1930's to the late 1950's, equity investors viewed dividends with much suspicion. The experience of dividend reductions and eliminations during the Depression was then fresh in investors' minds. Not only did investors fear dividend cuts, but they also lacked confidence in the future growth of dividends. This anxiety was particularly evident in the late 1940's when a postwar depression was widely anticipated.

While it was not foreseen at the time, the country was on the verge of a sustained period of economic growth, not depression. As the economy proved to be resilient, a new generation of investors emerged which, based on its experience, gained faith in stocks as a viable medium of investment. By the late 1950's stocks were yielding less than bonds and the spread has continued to widen since, albeit irregularly.

Except for relatively brief periods, stocks proved to be a better investment than bonds during the postwar period. This was so partly because stocks began the period in relative disfavor and were, in fact, incredibly cheap. Investor preference for bonds over stocks in the early postwar period is illustrated by the fact that the Standard & Poor's 500 was then yielding 6% and AAA corporate bonds were yielding about 3%. Also contributing to the better performance demonstrated by equities was the fact that corporations proved capable of adjusting to inflation and with rising earnings delivered rising dividends to their owners.

In retrospect, bonds did not represent good value at the end of World War II. Yields were inadequate to compensate bond investors for the upcoming depreciation in their investment resulting from inflation. For four decades bond prices declined while yields rose. This lesson has now been burned into the minds of the present generation of investors.

Today, the situation is just the opposite of the late 1940's. Our experience is not of depression but on inflation. Conventional wisdom is that there is a bias toward inflation in our economy. Investors are showing a decided preference for stocks over bonds as illustrated by the fact that the current income numbers have reversed. Bonds now yield in excess of 9% while stocks yield less than 4%.

The ability of corporations to increase earnings and dividends gives equities a decided long-term advantage over bonds. However, the difference in the current incomes of the two investment mediums suggests that we should own a few more bonds and not quite as many stocks a today's levels. It seems prudent to hedge our bets in this fashion as investor expectations about the future may prove to be no more accurate now than they were in the late 1940's.

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