Lesson 2 – Inflation

Ten years ago, $1 was worth more than $1 is worth today. Back then, $1 could have bought far more things than we can buy now.

This is what is referred to as Inflation. In essence, the *value* of money depreciates over time. So even though you may be saving money in the bank, the *value* of that money will be worth far less in the future.

Here is an example. In 2018, the inflation rate in the United States was about 2%:

- Lets say that you have $10,000 in your savings. Normally that $10,000 would buy **$10,000** worth of goods.
- With inflation, it can now only buy **$9,800** worth of goods because of this 2% inflation rate!

Before moving on, let us define some important terms:

STOCKS

Part of a company that is for sale. When you invest in a stock, you are a partial owner of the company, however small.

BONDS

When you invest in a bond, you are lending your money to a company or government as a loan.

LIABILITY	ASSETS
What you owe e.g. Mortgage Car loan Credit cards	What you own e.g. Stocks Savings Account Property owner renting to others

Now let us move on.

Inflation can be both good and bad

Inflation is 'good' when you are borrowing money. Inflation is 'bad' when are lending money.

Good:

Imagine you are borrowing money to buy a home.

- So you borrow $250,000 at a 6% interest rate.
- Let us say the inflation rate is 2%
- Because of this, you are effectively paying a 4% interest rate on that house instead (6% – 2%)
- Why? Because inflation is eating away at the $250,000 *value* that the lender originally gave to you.

Therefore the lender is impacted by inflation.

Bad

Remember, when you invest in a bond, you are ***lending*** your money to a company or government as a loan. So anytime you buy a bond, it is completely impacted by inflation.

Therefore if you are investing in bonds, you need to assess the impact of inflation on the returns that you are expected to get.

What about stocks?

Stocks are also impacted by inflation, but not as much as bonds are. So although stocks are not an absolute protection against inflation, they are definitely better than bonds.

Warren Buffet believes that a stock is impacted by inflation based on the composition of tangible assets and capital expenditure:

- Composition of tangible assets: Every company has tangible assets/liabilities and intangible assets/liabilities:

Tangible	Intangible
Buildings Furniture Property	Software Intellectual Property

- Capital expenditure: Tangible assets/liabilities have greater capital expenditure because they require a lot of money to maintain and replace. Intangible assets/liabilities do not require much money for unkeep.

Tangible assets/liabilities are therefore impacted by inflation.

For example:

- Let us say that you invested in a company that has a bunch of tangible assets/liabilities and the inflation rate is 3%.
- These tangible assets/liabilities are subject to inflation.
- So if the annual return is 10%, the real *value* you will get as an investor is 7% (10% - 3%)

Real Estate Investment Trusts (REITs)

- REITs are companies that own and collect rent from buildings
- Investing in REITs are like investing in a stock
- These companies do well at combating inflation
- There are many types of REITs e.g. commercial property, residential property

Rhetorical Question Summary:

- What is inflation?
- What is a stock?
- What is a bond?
- What is the difference between an asset and a liability?
- Which is affected more by inflation: a stock or a bond?
- Which is affected more by inflation: tangible or intangible assets?
- What is a REIT?