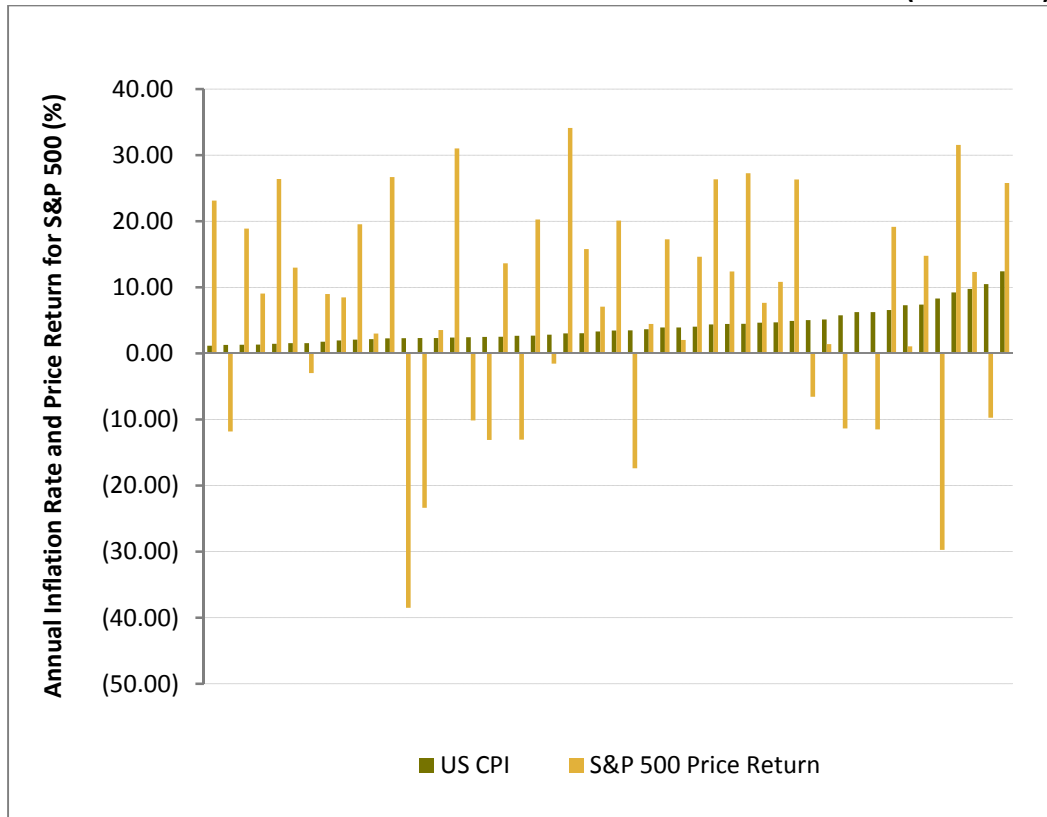


The threat of inflation is making some investors cautious about equity markets. They wonder, “How will it affect my portfolio?”

Benjamin Graham, widely regarded as the father of value investing, addressed this question in his book, *The Intelligent Investor*. He wrote, “There is no close time connection between inflationary (or deflationary) conditions and the movement of common-stock earnings and prices.”¹

Examining Graham’s assertion, we compared price returns for the S&P 500 Index and the U.S. Consumer Price Index (CPI) between 1959 and 2008. We sorted the data from lowest annual CPI rates to the highest and show the pairs of data in Exhibit 1. Each pair of yellow and green bars reflects the annual price return for the S&P 500 Index and annual inflation rate for one year. Underscoring the lack of a visible relationship in the chart, the correlation between these variables was 0.01.

Exhibit 1: Annual Price Return for the S&P 500 Index and Annual U.S. CPI (1959-2008)



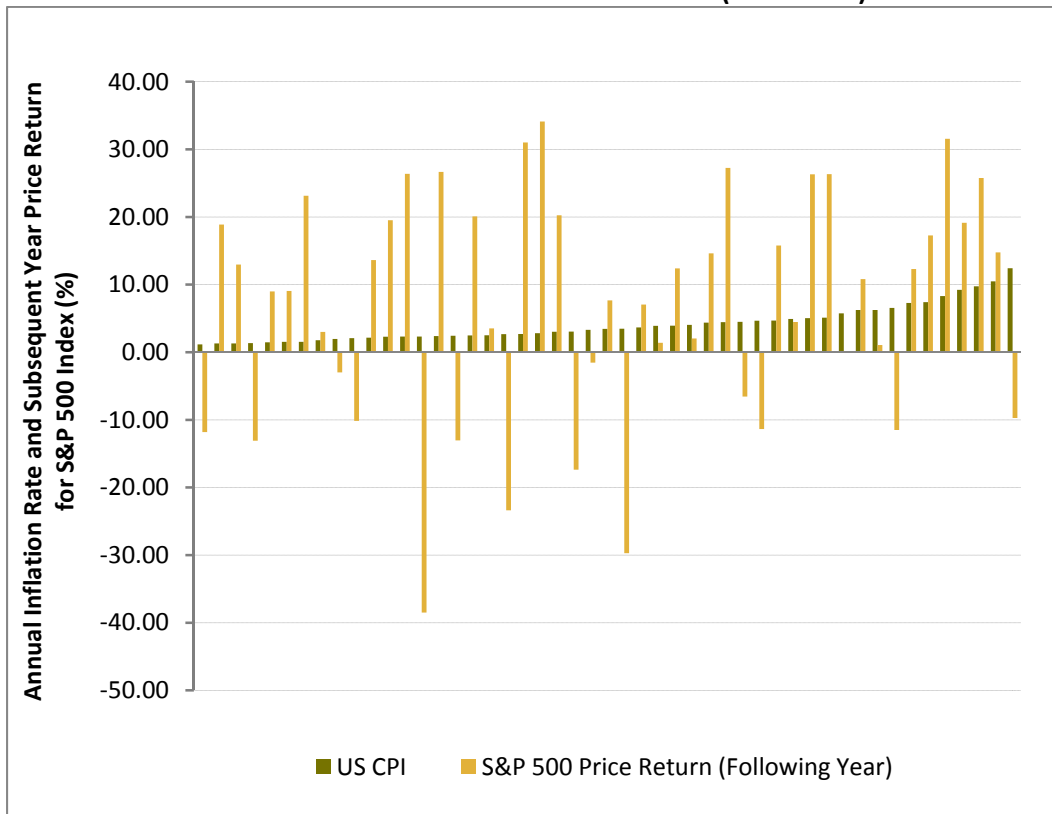
Source: FactSet, as of 12/31/08

Past performance is not a guarantee of future results.

¹ Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. 4th Revised Edition. New York: HarperCollins. 2003. Page 51.

We also looked at the relationship between inflation rates and *subsequent* stock market returns. We paired annual CPI rates with annual price returns for the S&P 500 Index for the following year. Then, we sorted those pairs of data again from lowest annual CPI rates to the highest and show them in Exhibit 2. Similar to the results in Exhibit 1, there was virtually no historical relationship between current year inflation and stock market returns the following year.

Exhibit 2: Subsequent Year Annual Price Return for the S&P 500 Index and Annual U.S. CPI (1959-2008)



Source: FactSet, as of 12/31/08

Past performance is not a guarantee of future results.

History doesn't show a relationship between inflation and stock market returns. Yet Graham noted that investors who are more dependent upon income from their portfolios might want to adjust their allocation between stocks and bonds to accommodate inflation threats. He wrote that an investor "cannot afford to put all his funds" in bonds or stocks, exclusively. At the same time, Graham acknowledged that stocks may not always be the best defense against inflation in the short term, but endorsed stocks as a viable asset class to help counter the erosive effects of inflation over the longer term: "There is no certainty that a stock component will insure adequately against such inflation, but it should carry more protection than the bond component."²

² Graham, Benjamin. *The Intelligent Investor: A Book of Practical Counsel*. 4th Revised Edition. New York: HarperCollins. 2003. Pages 56-57.

The S&P 500 Index with gross dividends is an unmanaged, market capitalization weighted index that measures the equity performance of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it can also be a suitable proxy for the total market. This index includes dividends and distributions, but does not reflect fees, brokerage commissions, withholding taxes, or other expenses of investing.

CPI is an inflationary indicator that measures the change in the cost of a fixed basket of products and services, including housing, electricity, food and transportation. The CPI is published monthly. Also called the cost of living index.

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