

Spotlight on Purchasing Power Risk

Most of us can remember when a million dollars was a huge amount of money. A millionaire was wildly rich, with money to burn and not a care in the world. Now we see books like *The Millionaire Next Door*, which explain how thrifty people in “dull normal” professions comprise the bulk of the millionaire population. Millionaires are not as rare as they used to be, and a million dollars no longer signifies tremendous wealth.

Why is this? Prices for goods and services increase over time, and wages more or less keep up. In 1924 a movie ticket cost 25 cents. Now it costs an average of \$7.20. What explains these increases? Sometimes prices of goods and services increase because quality improves. Other times prices increase when businesses pass on the changes in the costs of paying their workers and suppliers.

Since 1924 movies have improved (technically, anyway). We now have color films, surround sound, enhanced digital animation, and super-comfy seats with cup holders. Think about the difference between *The Perils of Pauline* and the latest James Bond flick. Overall, prices are about 12 times higher than in 1924 (as measured by the Consumer Price Index, or CPI). If a movie ticket had increased in price only to keep up with inflation, we should be paying about \$3 now to go to the cinema. That would be the nominal price increase. The remaining \$4.20 increase would then be attributable to improvements in the technical quality of movies, and \$4.20 would be assumed to be the real price increase.

But wait a minute. Are movies really 16 times better than they were in 1924? How would we measure that? In the United States, the Bureau of Labor Statistics (BLS) has the responsibility for measuring changes in the prices and quality of goods and services. The BLS determines the composition and price of the basket of goods and services that make up the CPI. There is no clear-cut way to adjust the basket for changes over time, so the BLS has some discretion in adjusting for quality and in substituting items.

Because the government has many obligations that are tied to the CPI, the BLS has political and fiscal reasons to minimize the increases in the CPI. Many economists now believe that the way the BLS calculates the CPI underestimates inflation. One economist has tried to come up with a consumer price index that measures the changes in prices related to maintaining a constant standard of living. The “shadow CPI” statistics show that inflation has averaged 7.3% per year since 1982 rather than the 3.1% rate quoted by the BLS. Any financial instrument with returns tied to the CPI, including TIPS (Treasury inflation-protected securities) and many annuities and pension payments, may not keep up with actual inflation.

Perhaps movies are not really 16 times better than they were in the 1920s. According to the shadow CPI statistics, movie prices have not kept up with overall inflation. Maybe the quality of films is lower than in 1924, or movies are subject to greater competition, or they benefit from greater economies of scale. If the shadow CPI is correct, then we have all been fighting a significant headwind of rising prices.

Why should you care about increasing costs of goods and services? You save money now in order to meet goals for future spending. You need your current savings to be able to fund future purchases of goods or services. Perhaps you want to invest money now in order to pay for college in 10 years. The average cost of a four-year college has increased by almost 4% per year over the past 10 years. If you cannot increase the value of your investments by at least 4% per year, then you will not be able to pay for as much college as when you began.

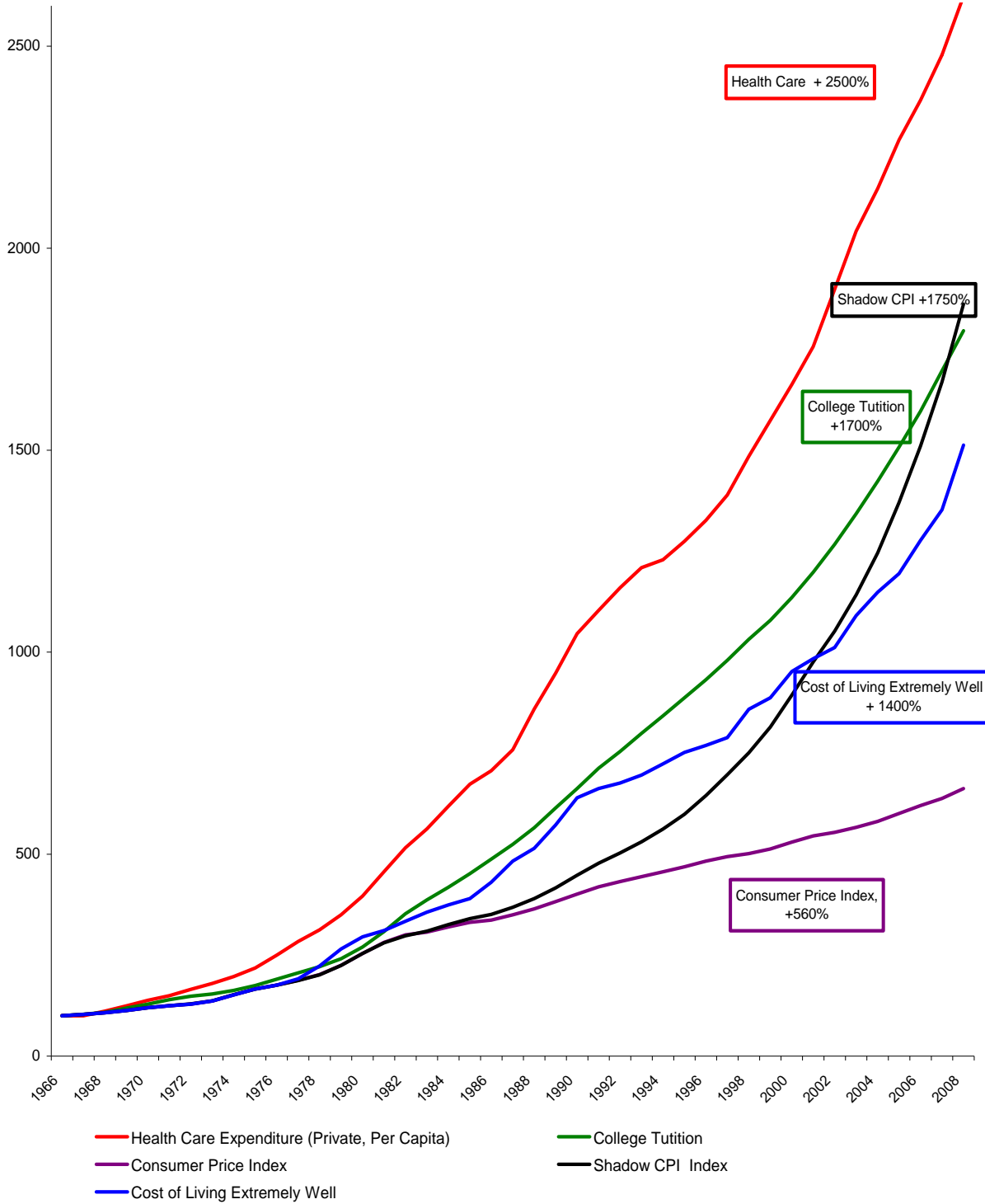
We call this purchasing-power risk, which is the risk that the buying power of your savings erodes over time. This can happen because of either real or nominal price increases. Either way, though, investors who want to preserve the power of their savings need to make sure that their investment accounts keep up with the increases.

If you look at the graph “How to Measure Inflation” on page 3, you will find several representations of the way prices increase over time. You will see that some costs, like health care, are increasing faster than any index. You will also see the divergence of the various measures of the consumer price index. One item of note is the “Cost of Living Extremely Well” index from *Forbes* Magazine, which includes luxury items such as opera tickets, sable coats, thoroughbred horses and caviar. Although few among us regularly buy these items, this index is worth following because its components change very little over time (a horse is a horse, of course), and because it illustrates the effects of price changes on important items that are not included in the CPI, such as a year at Harvard or the services of reputable lawyers.

How do we help protect against a loss of purchasing power? We invest in assets that we expect will provide a real return – we expect them to appreciate faster than the costs of the goods and services we will wish to buy. Over the past 40 years, guaranteed investments in 6-month CDs have outperformed the BLS’ Consumer Price Index, but they have lagged the Cost of Living Extremely Well index and have fallen far short of the increases in the shadow CPI, college tuition, and private spending on health care. So we invest instead in assets that we expect will keep up with the *true* cost of living. Because there is no such thing as a free lunch in investing, assets that have high expected real returns also come with higher risks.

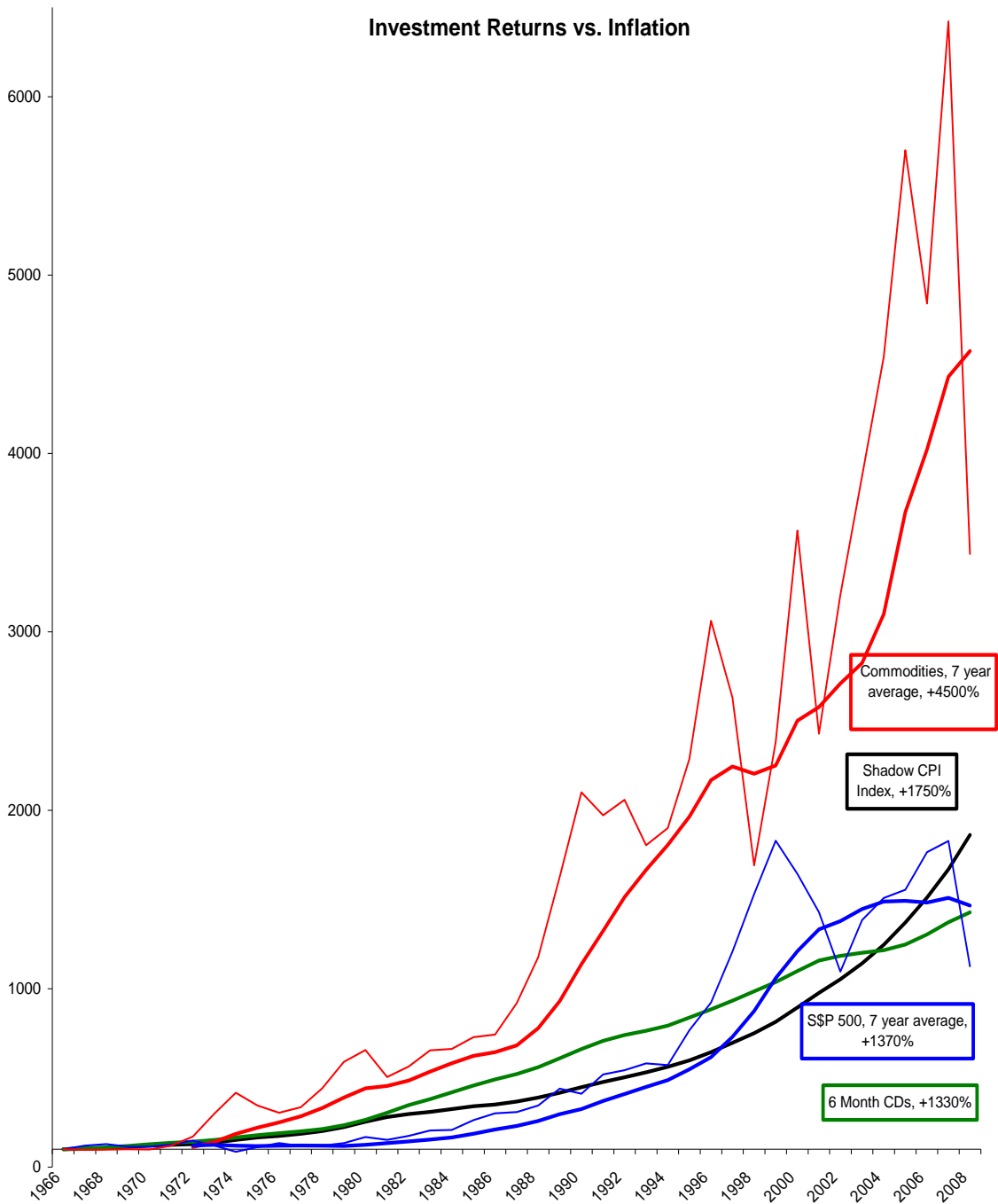
The graph “Investment Returns vs. Inflation” illustrates both the risks and rewards of investing in stocks and commodities (see page 4). You will notice that commodities, which serve as the inputs to production, respond violently to changes in supply and demand, but over time they have provided a real return above inflation. From 1901 to 2008, the US stock market has returned, on average, approximately 2.6% above the CPI. As we all know, this has not been true for every time period. That is why such an investment is risky, and why, over the long term, investors demand compensation for market risk. For this reason, we at Contango will work together with you to determine the best balance between generating a significant real return and preserving capital.

How to Measure Inflation



Sources: Shadow Government Statistics, Bureau of Labor Statistics, Bloomberg, Contango analysis

Investment Returns vs. Inflation



— Shadow CPI Index
 — 6 Month CD Compound Returns
 — S&P 500
— Goldman Sachs Commodity Index
 — Commodities, 7 year average
 — Stocks, 7 year average

Sources: Shadow Government Statistics, Bureau of Labor Statistics, Bloomberg, Contango analysis

IMPORTANT NOTE:

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