

Beating inflation — real estate looks like best bet

Chicago Tribune

Even if investors had 20-20 foresight to guide them in their selection of investment vehicles, their vision would be clouded by inflation — expected and unexpected.

Thus two researchers have been prompted to investigate the inflation-hedge values of several assets, such as common stocks, private residential real estate, government bonds and bills, and labor income.

The researchers are Eugene Fama, professor of finance at the University of Chicago Graduate School of Business, and William Schwert, assistant professor of finance at the University of Rochester Graduate School of Management. They published their findings in the December, 1977, issue of the *Journal of Financial Economics*.

In a nutshell, the authors find that private residential real estate is a complete hedge against both expected and unexpected inflation, and that U.S. government bonds and bills are a complete hedge against expected inflation. Labor income shows little short-term relation to either expected or unexpected inflation. Common stock returns are negatively related to expected inflation and probably also to the unexpected inflation rate.

The period chosen for the comparison study was 1953 through 1971, with the common stock results extended through 1975. "Pre-1953 stock returns are just not related to either expected or unexpected inflation," Fama says. "In the early 1950s interest rates and expected inflation were very low and returns on common stocks very high. After

1968 you get just the reverse."

They use a statistical technique called regression analysis to estimate, for example, the relationship between interest rates and common stock returns.

The basis of inflation-hedge analysis is Irving Fisher's 1930 theory that the nominal interest rate on bonds is the sum of the real interest rate — the purchasing power of interest — and the expected rate of inflation.

"He (Fisher) hypothesized that the expected real return is determined by real factors, like the productivity of capital, investor time preferences, and tastes for risk, and that the expected real return and the expected inflation rate are unrelated," Fama and Schwert write.

Thus, the going interest rate on a one-, three-, or six-month Treasury bill is taken as the expected rate of inflation for that period. The difference between the monthly rate of change in the consumer price index at the end of a month minus the one-month Treasury bill interest rate observed at the beginning of a month is taken as the unexpected rate of inflation.