HOW AVERAGE PEOPLE ARE BEING SWINDLED EVERYDAY

There's an invisible force out there that is eating away at your wealth. It attacks slowly, weakening its prey like an invisible parasite. It goes unnoticed until it's too late.

This thief is anonymous and worst of all, the common man doesn't know he exists. It doesn't care who you are, and it doesn't make exceptions. If you live in the developed world, this thief steals from you. Period.

The silent killer has a name. Inflation.

This is the number 1 enemy of your wealth. Inflation makes the very currency you hold in your hand worth even less. It affects anyone who has U.S. dollars or other major forms of fiat currency.

The effects of this phenomenon are substantial. The average rate of inflation has been 2%- 3% per year. If you take 17 years into account, that's already an over 50% inflation rate.

Which means the dollar you hold now will only buy you half as much in 17 years.

Doesn't that sound insane? But it's true. It's sad but true. This is the exact reason why things used to be so cheap back in the day. I'm sure your grandparents remember being able to buy a cheeseburger with 10 cents. Or a gallon of milk with 5.

What does 10 cents get you today? Not much of anything; I don't think anything even sells that cheap.

Inflation didn't always used to be this bad. It's only been more recently that inflation has really ramped up.

You see, in the past, U.S. coins were minted out of silver. The U.S. paper dollar itself used to be based on gold– called the gold standard.

What this presence of silver and gold did was limit an explosion in inflation. Because there is only so much gold and silver that can be mined in this world, there could only have been a limited amount of U.S. currency that could be created.

A Lesson in Economics 101

Money supply refers to the amount of money swirling around in an economy. When more money is printed, this allows more dollars to flow into an economy. This has a great trickledown effect, and does a part in kickstarting an economy.

For example, more money flowing into an economy will flow into the banks through deposits. With an increase in deposits, these banks have more money to lend. The increased lending results in more business growth, investment and consumer spending.

That increase in growth will lead to more money into the economy again, which will find its way back into bank deposits and out again. This is the cycle of money flow and the economy.

It all sounds good. Based on this example only, it seems like we should always be raising the money supply.

But you should know that nothing in this world is free. Every cause has an effect.

In this case, the increase in money supply does one major thing... that is, push up prices. Again for the uninitiated, prices are determined by supply and demand. Supply and demand counter each other. Their balance is what we call price.

So if you see a sudden increase of supply but equal demand, you get a lower price. If you have the same supply but a lower demand, you'll also see a lower price.

This becomes obvious when you think about the basics of consumer behavior. Think about the difference of the price of water and gas.

Water is cheap because we have such an abundant supply of it. Yes, demand is high, everybody needs water, but through advanced piping, we are able to tap into vast supplies of water instantaneously. The supply is high, so our price is low.

Think about gas as the opposite. Everybody needs gas, almost as much as they need water. But you can't just turn on a faucet to magically get a stream of gas. That gas needs to be drilled and refined from oil, then delivered and stored somewhere. These incremental costs can lead to a lack of supply, making oil and gasoline generally expensive.

An increase in demand leads to higher prices, while a decrease in supply will also lead to higher prices.

Supply and demand are what determine price. Price in a free market is not fixed, it is fluid and depends on economic behaviors.

Money Supply and Prices

What did we just learn about supply and demand, and how does it relate? Well, the increased money flow leads to increased demand of most services and products.

The increased economic activity leads to a need of more bankers, more employees of small businesses, more construction workers to build for the businesses… more demand for products and services.

What does an increase in demand do? It raises prices! The supply side is the same, there's a same number of banks, products being made, etc. The increased economic activity has a side effect of increasing demand, which raises prices.

And when you see prices go up, they make all the other prices around them go up. The hamburger joint who sees a 50% increase in the cost of onions and potatoes will then increase the prices of their burgers.

The construction company that sees an increase in prices of wood and steel will also have to raise their rates. The business person will have to raise their prices to pay for the increase in construction costs.

All around you'll see prices going higher. This is just one of the effects of increased money supply. This phenomenon is also known as inflation.

When cost of living gets pricier, this hurts the common person. While it's good for the economy and businesses, it's bad for the average worker.

The steeper that inflation rises means the less purchasing power of goods and services that each dollar can buy. And oftentimes, average wages can't keep up with the rise of inflation.

This is where the real problem lies.

Inflation Eats Away Wealth

Inflation makes your money less valuable. 3% inflation means your dollar is worth 3% less, or 97% of its original value.

That is the destructive power of inflation. This powerful force is taking away 2%- 3% of your wealth, every SINGLE YEAR. If you aren't making 2%- 3% raises every year, you are losing to inflation.

If you aren't making at least 2%- 3% gains on your investments, you are losing to inflation.

Are you wondering why markets can soar so high at times? Smart investors know that if they put their money in the bank, or even in certain bonds, it is likely to lose to inflation.

A bank account that is paying you 0.5% interest isn't making you richer; you are actually losing 2.5% every year, thanks to inflation!

It's hard enough to build wealth, and even harder when inflation is taking away 2%- 3% of it.

The Solution: Stock Ownership

The famous economist Irving Fisher probably said it best when he said,

"In steadiness of real income, or purchasing power, a list of diversified common stocks surpasses bonds".

A diversified portfolio of stocks is simply a collection of shares. Shares represent partial ownership of a company.

Whoever owns the majority of shares owns the majority of a company, and is entitled to the majority of its profits.

When a company goes public (IPO), they divide the company into shares and allow the public to bid for these. As investors, we can choose to buy the shares of any company we want, as long as we are happy with the price we pay for those shares.

From there, the company can continue to grow, and this makes everyone's ownership stakes more valuable.

Why?

Because the more profit a company can generate, the more it can eventually distribute to its owners, and the higher each share (partial ownership stake) will be worth.

What's great about a share of stock is that its supply generally doesn't become inflated over time.

As companies mature into cash generating machines, they usually don't sell additional shares to the public, and so the base of shares remains constant (or lowers as companies do stock buybacks).

With shares that remain constant, an investor's 10% ownership of a business still represents 10% ownership of that business tomorrow, regardless of whether a dollar is worth $1.00 or $0.50 tomorrow.

Inflation can erode a currency and destroy businesses that can't raise prices, but it can't directly erode the actual ownership stakes of an investor's stock—making them fantastic inflation hedges in this way.

The Best Kinds of Stocks Against Inflation

Even better, the best companies usually can raise prices to match inflation, because they are the best companies.

One fabulous example of this was Warren Buffett's purchase of See's Candies during the inflation-gripped 1970's.

See's Candies does not take much in the way of expenses to operate, and doesn't require heavy capital expenditures in order to consistently grow its profits every year.

Because consumers are loyal to the See's brand, they eagerly absorb any pricing increases even during economic uncertainty and/or inflation.

See's Candies is able to see its revenues grow as it increases prices while other expenses also rise.

But because those expenses are minimal, and See's doesn't take much capital to continue to mint free cash, its damages experienced from inflation are minimal, and the company is able to earn fantastic compounding rates of return for investors.

The same forces which contribute to the heavy competitive advantage of See's Candies, and its great growth, also protect investors against the insidious effects of inflation.

The fact that the company doesn't require huge investments of capital or large expenses in order to generate a lot of cash means that inflation's impact is limited, since inflation can greatly elevate the costs of expenses and large investments.

That, combined with its pricing power, allows the company to continue to excel despite high inflation, and is a great example of why buying great businesses is one of the best ways for investors to fight inflation— like we do with the monthly stock picks for The Sather Research eLetter.