A formula for wealth creation

One of long-term investors' most common errors consists in trying to place their investments into asset classes offering only very little hope for generating high returns. Thus, they are depriving themselves of the possibility to achieve really high earnings. Each asset class (cash, bonds, equity, real estate, gold, and others) has its own characteristics, and one of the main ones is that of long-term expected returns. Simply put, if you want to have high returns, the majority of the portfolio must consist of an asset class that allows achieving such returns. Which is it?

Let us start by presenting certain facts about where wealth is created and the historical returns of the basic asset classes. Then we will think about why these things are as they are and, above all, whether this will remain so also in future.

Forbes magazine regularly publishes rankings of the richest people in the world. About a year ago, it occurred to me to take look at what made the world's richest people rich.

What I found was that 48 of the world's 50 richest people earned their wealth due to owning equity in some company, and the remaining 2 did so by investing into real estate. There is not one among the richest people in the world who built their wealth by hoarding cash or gold or by investing into land or bonds. As we shall see later, this is no coincidence. Equities are unequivocally king, and it does not matter whether this consists of an equity share in a publicly traded company (like Jeff Bezos and Amazon or Warren Buffett and Berkshire) or in a private one (such as Michael Bloomberg and Bloomberg).

The Czech Republic also provides a nice example of this. In the list of Czech billionaires, you will scarcely find anyone who has acquired his or her wealth in any way other than by owning stock in some company, and in almost all cases these are private companies that are not traded on the stock markets. The basis of investing into stocks is regular flow of cash from the companies to their shareholders in the forms of dividends and share buybacks along with reinvesting retained earnings. This is true for both publicly traded and private shares.

A second basic set of facts concerns historical returns of basic asset classes. Jeremy Siegel in his legendary book *Stocks for the Long Run* presents a nice graph with real – that is, inflation-adjusted – returns of basic asset classes in the US for the period 1802–2015. The returns are as follow: Cash yielded a loss of 95%, gold had real returns of less than 3-fold, treasury bills (essentially close to bank deposits) had 273-fold returns, bonds 1,659-fold, and stocks more than 1,000,000-fold. (In addition, perhaps to the surprise of many, stocks also had the lowest deviation from their long-term trend.)

Some may wonder why there is no real estate in the graph. It is difficult to assemble long-term real estate indices, and they are few and far between. Probably the longest series is that of the Case–Shiller Home Price Index for residential real estate, starting back in 1890. In the 127 years from 1890 to 2017, its value has increased by approximately 8.5 times in nominal terms and by 70% in real terms, after adjusting for inflation. The low returns from residential real estate put it closest to gold.

There are very great differences among the returns from the individual asset classes. That is just a fact. A question, however, is whether this is by chance or if there is some clear logic behind it. And how do these historical returns of the individual asset classes relate to the fact that the world's richest people acquired their wealth almost without exception due to equity ownership? Is this not just a coincidence?

What in fact determines what the returns of the individual asset classes will be? I believe there are three main factors. These comprise the human factor, basic risk compensation, and capital accumulation.

The human factor. We can imagine every company as a living organism in which people create value through their activities, their ideas, creativity, effort, work. Through all this, they contribute to growth in the value of the companies in which they work. The influence of the human factor may not always be positive, but it is unequivocally positive on average. No one really doubts the influence people such as Bill Gates, Steve Jobs, and Amancio Ortega have had on the value of their companies. But we need not think in such extremes. The same effect of the human factor can be observed in firms all around us, and value is not created by leaders only but by everyone working in a company.

The influence of the human factor and value creation is much greater in companies than in, for example, land and real estate. Although people do create value there, it is greatly limited by the size, character, and location of the particular property. In the case of companies, people have much more room for creativity and companies are much more flexible in responding to external developments and exploiting various opportunities. The influence of the human factor on bonds is minimal, and it is zero in the cases of cash and gold. Whatever you do, you will not influence the price of gold on world markets or change the nominal value of a bank note.

Risk compensation. When a company gets into trouble, the creditors' claims take precedence over the demands of shareholders. It is therefore logical that investors want to be compensated by higher returns for the risk they undertake in relation to owning a company's stocks vis-à-vis returns to those investing into its bonds. Over the long term, equities must therefore return more than bonds. The opposite relationship would make no sense. If lending to companies brought more money than their ownership, no one would want to establish companies. Everyone would just want to lend, but there would be no one to lend to. Again, real estate falls somewhere between stocks and bonds. Cash is at the lowest position, because its nominal value does not change. Gold is in a category of its own. It has no intrinsic, fundamental value, generates no returns, does not multiply, and is not useful for very much.

Capital accumulation. Perhaps the strongest reason in support of investing into stocks is the speed at which accumulation of capital takes place at the level of owned companies. If, for example, a company has equity of one billion and return on equity of 15%, then its annual profit would be 150 million. If it reinvests this entire sum, which means equity at the beginning of the second year will be 1.15 billion, and if the rate of return on equity remains the same, then its profit in the second year will be 172.5 million. And so on year after year.

The trick lies in the fact that in stocks the returns to capital and the rate of capital accumulation are incomparably higher than in other asset classes. The proverbial snowball rolls up fastest in stocks, by far. Of course, capital accumulation occurs also in bonds, real estate, or land, but at a much slower rate. It does not occur at all in the cases of cash and gold.

This brings us to something we could call the Formula for Wealth Creation. This is what it looks like:

Wealth = (Human factor + Risk) * Capital accumulation

If we want to have high long-term returns, then we must invest into asset classes in which the human factor substantially helps to grow value, where the general risk undertaken is compensated by high return, and where rapid accumulation of capital occurs. As we have seen above, equities offer the best outcomes regarding all three points, and especially in their combination. We do not know how great will be the returns of the individual asset classes in the coming decades. They could be higher or lower than in the past. The crucial thing is that the ratios between the returns from the individual asset classes will remain. That means stocks will make much more money than bonds, real estate, gold, and cash.

The fact that the world's richest people – almost without exception – built their wealth through stock ownership is no coincidence. This aspect of the ranking will not change in 5, 10, or 50 years. Ownership of stocks in smaller amounts has the same impact on wealth. Even among the common people, the middle class, and entrepreneurs, those who own a share of some company will be wealthier than those who do not. In many cases, these will be private companies. The three factors of wealth creation have the same effect on their returns as they do on those of publicly traded companies. The disadvantage is that shares in these companies cannot be freely acquired and traded. Luckily, there are equity markets. The best thing about them is that they allow anyone to acquire shares in various companies all over the world and to put their capital to work at negligible cost. Essentially, at any time and without limitations. Freedom to such an extent is all too scarce in today's world.

Invest with care!

Daniel Gladiš, 18 January 2018

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