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Arne Alsin: Owners can claim an advantage in the long run

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Data show that stocks generate higher returns than any other asset category over the long term. But data aren't necessary to make the case. A powerful argument can be made through a proper understanding of stocks.

Asset classes can be put into two broad categories. There are "do nothing" assets and "do something" assets. The do nothing category includes a variety of assets, such as precious metals and raw land. When left untouched, these make no product, render no service, and generate no income. It should come as no surprise that the long-term return from them approximates the rate of inflation.

The list of do something assets includes investments such as certificates of deposit, stocks, bonds, and T-bills. The do something category includes sub-categories commonly known as debt and equity.

I prefer to distinguish between debt and equity investors as "loaners" and "owners". If you invest in debt, you are a loaner. You lend your capital to the government in exchange for a T-bill, to a bank in exchange for a CD, to an insurance company in exchange for an annuity, or to a corporation in exchange for a bond.

If you invest in equity, you are an owner. Buy an interest in the local car wash and you are an owner. Buy shares in Starbucks, Coca-Cola and Nike and you are a part-owner of these companies (I am not).

In general, it is better to be an owner than a loaner. The upside is unlimited for owners, while the upside for loaners is fixed. When you lend your capital to the government, you will get back the capital you lent plus interest and not a penny more.

Alignment of interests puts owners in a much more enviable position than a loaner. Ask your bank how much interest it will pay on a CD. You and the bank have competing objectives. You want to make as much as possible and the bank wants to pay you as little as possible.

Instead of lending capital to your bank through a CD, consider the alignment of interests if you bought stock in the bank instead. All big decisions at the bank, such as how much interest to pay on savings accounts and how much to charge for loans, are made with the owners' interest in mind.

Control is an important advantage owners have. For example, when a loaner lends capital to a business, control of that capital is ceded to the business.

Adaptability is a significant advantage that owners have over loaners. When they make a loan, lenders are implicitly betting their capital will not be impaired by future change. A jump in inflation is one example of a change that can harm a loaner. A long-term bondholder is stuck when inflation jumps because adaptation to a higher inflation environment is not possible.

The ability to adapt to change mitigates capital risk for owners. The owner of shares in Coca-Cola does not have to make a bet on how consumer beverage preferences will evolve. Whether demand surges or not is not an issue. That owner only has to bet that Coca-Cola management will adapt accordingly.

The fact that casinos take a significant percentage of the total bets placed means that, as a group, bettors lose money. The odds are stacked against you if you bet in casinos consistently over the long term.

In the stock market, the opposite is true. There is a high probability of success with consistent investment over the long term. I call it the "inevitability of reward". Businesses exist to make profit. As profits accumulate, value accumulates. Since 1920 the combined companies in the Dow Jones Industrial Average have been profitable every year, with the single exception being a small loss in 1932.

It's likely that over the next 10 years the total cumulative profit of Starbucks, Coca-Cola and Nike will be impressive.

With that in mind, is it a good bet that these companies will be more valuable in 10 years? That is for you to decide.

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