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TELLING TALES

A Lot of What Investors Hear Is More Fiction Than Fact

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Humans are storytelling animals. But what if the stories we tell aren't true?

Over my 36-year career, I've heard countless financial stories. Three of the most enduring: that interest rates will inevitably increase, that tax rates will inevitably rise and that stock market valuations will inevitably revert to their historical averages. These aren't crazy stories. In fact, you can make a strong case for all three.

But there's just one little problem: So far, at least, none has proven to be true. In the meantime, however, many who believed these stories sat with lopsided portfolios—often long on cash investments, or municipal bonds, or short-term Treasurys—only to find themselves missing out on substantial stock market gains.

That brings us to a fourth, more recent story: inflation. It's making a comeback, right? It almost seems like a silly question to ask. Without a doubt, higher inflation is the narrative of the day, one that—to use the language of the internet—has "gone viral." In recent months, the Bureau of Labor Statistics has been reporting 12-month increases in the consumer price index in excess of 5%.[1] Many financial experts are saying the days of sub-2% inflation are over.

But forget the data and the experts. What's really powerful is the anecdotal evidence we see in our daily lives and that we hear from family and friends—things like bidding wars for homes, higher prices for used cars, absurdly high contractor bids for remodeling projects, steep jumps in the price of gas. Have you tried to get a restaurant reservation lately? Have you seen those half-empty lots at car dealerships? Such stories pack a punch. As Soviet leader Joseph Stalin is reported to have said, "If only one man dies of hunger, that is a tragedy. If millions die, that's only statistics."

Stories don't just deliver compelling "evidence" that shapes our opinions. They're also our way of making sense of the world. The financial markets are enormously complicated, with prices driven by millions of investors, each acting for their own unique reasons. Despite what you might read in the newspaper or hear on cable business news, there's never a single explanation for why the financial markets rise or fall on any given day.

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[1] *https://www.bls.gov/cpi/*

Still, we want to make sense of what's going on—and simple stories allow us to do just that. Such as the story that inflation is making a comeback.

I have no crystal ball, so I can't tell you what will happen to inflation. The comeback story could indeed turn out to be true. But let me tell you another story, one that strikes me as equally plausible. It's possible that today's price increases will prove transitory—the temporary result of supply chain disruptions caused by the pandemic, a changing workforce, loose monetary policy and high government spending. Soon enough, higher interest rates and fiercer global competition will rein in price increases, and once again we'll be back to annual inflation of 2% or so.

Admittedly, even if this narrative is equally plausible, it isn't the one that's currently believed—and that's a potential problem. As Nobel prize-winning economist Robert Shiller has pointed out, such narratives don't merely reflect what's happening. Rather, they influence our behavior and that, in turn, can change the course of events.

Consider the damage that could be done by the inflation narrative. We might see folks rush to buy now—perhaps with borrowed money—because they fear consumer prices will be even higher six months from now. That extra demand might then drive prices yet higher, causing inflation to accelerate. Meanwhile, those looking for work may hear stories of wages going up, so they hold out for higher pay. Unable to find new workers, employers are compelled to raise wages, which they then pass along to consumers in the form of higher prices. And so it goes on. Before long, the inflation story we tell each other could become the reality that truly hurts our financial lives.

Even if the inflation narrative doesn't turn into a self-fulfilling prophecy, it might do a heap of damage to our individual finances. Convinced that inflation will get yet hotter, perhaps we'll move substantial assets into gold, real estate or commodities as a hedge against inflation. Perhaps we'll worry that higher inflation will mean higher interest rates, which will then wreak havoc with bond and stock prices, and so we lighten up on both. What if we're wrong on all counts? We might end up missing out on a major stock and bond market rally.

In other words, like so many financial stories that get told, we don't know how this one will end. What to do? We could predict the ending and bet our money accordingly. Or, we could accept our ignorance and do what prudent investors have always done—which is to diversify broadly, confident that we should do reasonably well, no matter how the story plays out.

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