The intelligent investor and Ben Graham’s adequate returns

Return on capital and return of capital

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An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. –Benjamin Graham

It is frequently preached that intelligent investors should safeguard their principal and look for a satisfactory returns on their investments. In short, first look for return of capital and then look for a return on the capital which is adequate.

Now how does one ensure a return of capital? We have discussed this earlier and we will discuss this in future. However, mostly the easiest way for people to not get a return of capital is to chase unrealistic returns on capital.

So, let’s try to understand return on capital that are adequate, that are realistic, and that are optimistic but possible, and then focus on return on capital that are unrealistic and destructive to your financial health.

The basic idea of return on capital comes from having a person postpone consumption. If someone has to part with her money, i.e. postpone consumption, she would want to be compensated for it with the promise of a larger amount of money at a later date, which will help her consume more than she could have consumed if the money was spent today. This extra portion of money is the return on capital.

The lowest amount a person can accept is the original capital with at least a return that will compensate for inflation. This will give her the same amount of consumption power or purchasing power as at the time of parting with the capital. So, she would want a little bit more. In India, long-term inflation is approximately 7% per annum (p.a.). India’s long-term growth rate in population is about 2% p.a. So, a gross domestic product (GDP) growth of 2% happens without any enhancement in productivity. A real growth in GDP of 2% plus 7% inflation gives a 9% p.a. nominal rate of return for GOI (Government of India) bonds. This is the lowest post-tax return anyone would want. However, in reality, this is the pre-tax return that one gets in India.

On the higher side, the long-term return on equity of Indian companies is nearly 20% p.a. This is the sustainable return one can expect on long-term equity holdings. Listed equities held for one year or more are subject to zero taxes.

Depending on the risk taken, one should, therefore, expect somewhere between 9% and 20% p.a. Something in this range is an adequate return on capital. Should one chase return higher than this, one is likely to not only not get the tantalizing returns but also the return of capital is likely to be at risk.

In reality, government bonds and fixed deposits will yield post-tax returns of 5-6% p.a. and equities have yielded 16-18% p.a.

If one enters equity markets when Mr Market is in an extremely pessimistic mood, then one can get equities at nearly 30-35% discount. If the discount works out over the next three years or so, then one has obtained an extra 10% p.a. over the return on equities. So, 20+10 = 30% p.a. returns are possible in equity markets from market troughs to peaks.

Any return higher than this over the long term should be analyzed carefully for sustainability.

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