BANISTER FINANCIAL, INC.
Business Valuation Specialists
www.businessvalue.com

1338 HARDING PLACE • SUITE 200
CHARLOTTE, NORTH CAROLINA 28204
PHONE: 704-334-4932 FAX: 704-334-5770
Contact: George B. Hawkins, ASA, CFA, President

FAIR VALUE™

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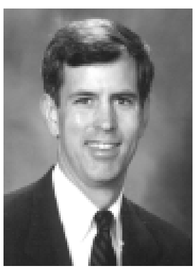
Active Versus Passive Appreciation- The Same Old Inflation Argument- But Is It Valid?

By: George B. Hawkins, ASA, CFA

Introduction. If you are a family law attorney with a business valuation equitable distribution case involving active and passive appreciation issues, the following argument advanced by some "experts" will sound familiar: *"The company was worth $1 million when the couple married and $2 million when they separated 20 years later. With just inflation alone that $1 million would be worth $3 million by the date of separation. Therefore, your honor, all of the appreciation in company value is passive, and therefore not marital property."*


George Hawkins

The central issue is whether or not such a direct and positive linkage exists between changes in company value and inflation? If so, what is the impact of this relationship? This article will briefly examine what research indicates and why the answer is not what you might expect. Also discussed are some commonsense reasons why the heavy emphasis on inflation logic falls apart.

"Active" and "Passive" Explained. A spouse will often own shares in a closely-held business prior to getting married. If the couple later divorces, in North Carolina the shares brought to the marriage are considered "separate" property for equitable distribution purposes in dividing the marital pot between the parties. However, any portion of the appreciation in the value of the business that occurs between the date of marriage and the date of separation which can be shown to be the result of the active efforts of the spouse is considered to be marital property subject to division. Likewise, any appreciation deemed to be the result of passive forces is still considered the separate property of the spouse who brought it to the marriage.

Although this article deals with business valuation, real estate provides a good simple analogy of these components at work. Suppose the owning spouse brought 1,000 acres of undeveloped land to the marriage, worth $1,000,000 at the time of the couple's vows. The couple separates 20 years later and the same undeveloped land is now worth $3,000,000. Rapid growth in the local community and the general appreciation of real estate has now made the property far more valuable, despite nothing having been done to the property. The $2,000,000 increase in value that occurred during the marriage is therefore considered "passive" appreciation.

Suppose instead that during the marriage the owning spouse undertook development of the land, putting in water, roads and sewers, subdivided it into lots, developed a golf course, and began marketing the lots for sale to local builders. In this instance, at least some of the appreciation in value that occurred during the marriage might be argued to be the result of the "active" efforts of the spouse, and therefore subject to equitable distribution.

A Major Issue In Business Valuations. Since the closely-held business is often the largest asset in the marital pot, attention focuses on whether or not the appreciation in value from the date of marriage to separation is active or passive, and therefore, marital or separate property. The owning spouse's expert will often base his or her conclusion that the appreciation is all passive on the supposition that inflation alone, a passive force, accounts for most or all of the appreciation in value, as in the example at the beginning of this article. It seems that many attorneys and "experts" have come to accept the inflation linkage as a fundamental truth. The opposing counsel often lets the argument go completely unchallenged without delving into whether it is in fact a truth, and whether or not it really makes any logical sense at all. As will be shown, in most instances the foundation for the inflation linkage is poor, is not logical, and is contrary to the findings of a number of actual academic studies about the impact of inflation on company values.

If The Inflation Argument Were True… If there were such a direct and positive dollar-for-dollar linkage between inflation and company value then the following logical conclusions are implied:

- **A Guaranteed Rate of Return-** Investors in companies will always be guaranteed that their initial investment will increase by at least the rate of inflation, no matter what happens to the company or how it is run. Does the real world work this way? Of course not! Some companies thrive, prosper, and grow, some muddle along, and others fail disastrously and even go bankrupt.
- **Risk- Who Needs It?** Whether a company is highly leveraged (dependent on debt), has an aging technology, or an incompetent chief executive is irrelevant. Inflation will bail investors out.
- **Management- Take A Few Years Off- You're Irrelevant.** Taken to its logical extension the inflation linkage argument implies that management could literally take a vacation from the date of marriage to the date of separation and the company would still have increased in value on autopilot by at least the rate of inflation. Although this comment is directed at operating companies, take this implication to an extreme and see just how silly it is- the example of a sole practitioner medical practice. If the physician is not at the practice every day patients will go elsewhere, causing value to evaporate. Yet, under the inflation theory, value keeps right on increasing due simply to rising prices.

These are but a few of the many logical flaws with the inflation-passive appreciation argument. While they may sound extreme, they illustrate the shaky foundation of the heavy emphasis advanced on behalf of inflation.

What Research Indicates. A number of academic studies have been undertaken to examine the relationship between the values of publicly traded company shares and a variety of variables, including inflation. According to a key study in the *Journal of Finance* by Dr. Zvi Bodie, a well known finance researcher, only 23.91% of the variation (up and down) in annual stock returns is explained by inflation. In other words, only 23.91% of the variation in stock returns over time can be related to inflation (and then not on a dollar for dollar basis, i.e., a 10% increase in inflation does not mean a 2.39% change in value), with the other 76.09% of the change (variation up or down) in stock returns due to a wide variety of other factors. In other words, 76.09% of the variation in company share prices is influenced by elements other than inflation, and which may positively or negatively influence value far more than the small impact of rising prices. Further, Bodie's study indicates that if stock returns are compared on a month-to-month basis inflation explains only 9.53% of the total variation (up or down) in share prices.

In addition to the fact that inflation as a factor only explains a small part of the total variation in stock returns, the actual correlation (the direction and quantitative amount of the relationship) between inflation and stock prices is small. According to Firstenburg, Ross and Zisler *(Institutional Investor)*, inflation, as measured by the consumer price index, has a <u>negative correlation</u> of 15% to stock returns on the Standard & Poor's 500 Stock Index. That is, a 100% increase in the inflation rate causes stock values to <u>decline</u> by 15%, other factors held constant. <u>The key word is decline. That is, inflation is associated with a decline in company share values, not an increase</u>. Thus, the data actually says just the opposite of what is advanced by the "expert". That is, isolating the impact of inflation alone shows it hurts company values over time, rather than building in a guaranteed increase.

In fact, during the current stock bull market, with stock prices at the loftiest historic levels ever, it is routine to read commentaries in the financial press which <u>attribute much of the rise to a low inflation environment</u>. A business valuator with a solid understanding of the income valuation approach, and how discount and capitalization rates are developed, can also show the fallacy of the inflation argument and why the financial press takes this position, one that is contrary to the earlier "expert" opinion.

ACTIVE VS. PASSIVE (continued)

Conclusion. A multitude of factors impact company value over time, of which inflation generally plays only a minor part, and not in the direction and with the degree of emphasis purported in the courtroom. Every company is unique and impacted by a multiplicity of issues that impact risk, opportunities and, ultimately, value. These factors defy the neat and tidy attempt to simplistically ascribe overriding emphasis to one factor such as inflation. Attorneys in equitable distribution cases should stop accepting the inflation myth as reality and not let it go unchallenged. Only in a few types of situations is inflation actually the force that it is claimed to be. ♦

George B. Hawkins is co-author of the *CCH Business Valuation Guide* and a Managing Director of Banister Financial, Inc., a business valuation firm in Charlotte, North Carolina. He can be reached at ghawkins@businessvalue.com or 704-334-4932.

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