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Nominal V. Real Returns

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Whilst most investors await a rise in the UK interest rate later this year, we continue to be amazed by the focus on this nominal rate in an environment where inflation is running at over 3% as we cannot see its relevance to an investor. Since the late 1970s we have become accustomed to nominal interest rates providing a 'real' return to investors as inflation was falling and interest rates fell gradually to the current near zero rates world. In such an environment, holding cash was a sensible investment choice as it came with little cost (a margin below the Bank of England's base rate) and preserved your real wealth.

We speak to a lot of clients and this provides an input into our overall thinking as these clients are ultimately a subset of the broader economic picture that is painted by the official statistics at country/global level. One of the key questions over recent years has been to ask what will happen when interest rates rise? Our response is usually "in nominal or real terms"?

This may sound flippant initially, however, we always consider interest rates in the context of inflation. If interest rates were to rise to 1% whilst inflation is averaging 3%, this doesn't make it more attractive as it still provides a negative 'real' return. If they were to rise to 4%, then we would have a conversation on our hands.

Our focus on 'real' returns is based on actual UK data from 1900 (provided by the Barclays Equity Gilt Study and updated annually). This data shows that a focus on nominal returns has led to significant 'real' losses for investors over prolonged periods of time as interest rates have remained below inflation for nearly 50% of the 117 year period.

	1910-1920	1940-1950	1950-1960	1970-1980	2
Cash	**-4.9**	**-2**	**-1.2**	**-3.3**	**-2**
Equity	-3.8	3.8	12.9	-2.3	5
Gilts	-8.6	0.5	-3.2	-4.1	4
Inflation	8.2	2.8	4.1	13.1	2

Source: Barclays Equity Gilt Study 2017

All returns are real geometric average annualised percentages

The last 10 years may feel unusual to investors, but the history shows that periods such as this have occurred regularly in history and we should not be anchoring our thinking on the 30 years prior to the financial crisis. We remain firmly of the opinion that inflation in the UK will remain higher than cash rates for the foreseeable future and this could last well into the next decade.

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