

Beware Money Illusion

Published on: 22 October, 2021 | Author: Investment Team

We have written many times over the past decade about the difference between real and nominal values. Preserving the real value of an asset means that it must grow in line with inflation over time. Nominal values are what most people notice, however real values preserve your purchasing power in the future.

In economics, money illusion relates to the human bias to think of money in nominal, rather than real, terms. In other words, the face value (nominal value) of money is mistaken for its purchasing power (real value) at a previous point in time. Measuring purchasing power by the nominal value is false, as modern fiat currencies have no intrinsic value and their real value depends purely on the price level. The term money illusion was coined by Irving Fisher in the early 20th century.

As inflation has been kept under control over the past 20 years and is now rising we think it is important investors are reminded again of this concept. This week's Thought focuses on how these affect individuals and next week we will follow up with how company revenues are affected in the current environment.

In the book "Why Smart People Make Big Money Mistakes", published in 1999, authors Gary Belsky and Thomas Gilovich looked at how three people, Peter, Paul and Mary, each bought a house that cost \$200,000 and all sell their property after a year.

In Peter's case, the country experienced 25% deflation in that year, and he received just \$154,000 for his house, 23% less than he paid. In Paul's case, a year later, inflation had risen by 25%. He sold his house for \$246,000, a 23% percent gain. In the year Mary owned her house, the cost of living is flat. At the end of the year she sold it for \$196,000, or 2% less than she paid. Taking inflation and deflation into account who was financially better off after selling their home?

Most people feel Paul does best because he's made a \$46,000 profit. But the real winner is Peter, even though he sold for a \$46,000 loss. Why? Because of inflation: Paul's profit falls 2% short of the inflation rate, so his purchasing power is diminished, as does Mary's. But Peter, despite what seems like a sizeable loss, comes out with purchasing power 2% greater than inflation.

Money is only good for what it can buy. So, what you can buy with your money at any point in time is more important than the absolute quantity you have.

When investing it is very difficult to keep real returns at the forefront of your mind as our mind plays the trick of money illusion on us. Preserving real values does not occur every calendar year, it fluctuates from year to year as asset prices fluctuate. The key point is however to continually setting a new real base for your assets. This is because it is highly likely that some of the return generated in the positive years will be given back during periods such as 2008 and 2020.

At Tacit, we firmly believe that equities are actually one of the best long term inflation hedges. By owning company shares you are buying a share of their cashflows into the future. These cashflows have historically risen with inflation as the prices charged by these companies are in essence what makes up our inflation rate. Unlike most, we are not focused on the current industry debate about potential rises in interest rates, on the contrary, we believe this noise is creating opportunities to allocate to well managed companies that will increase their cashflows with inflation over the coming years and also take market share from less well positioned competitors.

Important Information: Any views, insights, or commentary are for general information only, do not constitute personal investment advice or research, and are intended for UK residents. They may not be appropriate in all jurisdictions. While sourced from information we believe to be reliable, we make no guarantee as to accuracy or completeness. Past performance is not a guide to future results, and the value of investments can go down as well as up.

Regulatory Disclaimer: Tacit Investment Management is the trading name of TIML Limited (No. 9228395), part of Tacit Holdings Limited (No. 10611211). Both companies are incorporated in England and Wales, with the registered office at 14 Hanover Square, London W1S 1HN. TIML Limited is authorised and regulated by the Financial Conduct Authority (FCA ref. 670184) and approves and issues this communication under Section 21 of the Financial Services and Markets Act 2000. Please note, tax and estate planning services are not regulated by the FCA.