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The lure of big numbers

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Investors are often drawn to large nominal returns. The headline figures that are commonly used in marketing and reporting show the total percentage gain on an investment before accounting for inflation, taxes, and fees because these numbers are more visible, easier to understand.

Nominal returns provide a straightforward snapshot of performance, making them a convenient metric for quickly comparing different investment options, such as equities, bonds, or property, without the complexity of adjusting for inflation or other costs.

This focus on nominal returns is reinforced by the way financial products are advertised and reported. Investment providers typically highlight nominal figures because they appear more attractive and can induce a sense of higher profitability, even though these do not reflect the true increase in purchasing power. This highlights the importance of financial literacy and the need for investors to look beyond nominal figures to make informed decisions.

Psychologically, large nominal returns create a stronger emotional response and a sense of success, which can overshadow the more nuanced, but crucial, concept of real returns. Real returns require additional calculations and an understanding of economic factors like inflation, which may not be immediately apparent or easily accessible. For example, an investment may report a 10% nominal return, which sounds impressive, but if inflation is 7%, the real return, the actual gain in purchasing power, is only 3%. In reality a return of 5% when inflation is 1% is actually a better outcome for an investor.

Many investors, especially those less experienced or without financial training, may be induced by large nominal returns because they are simpler, more prominently displayed, and psychologically appealing, leading them to overestimate the effectiveness of their investments.

Real return is the true measure of wealth growth and purchasing power, and is at the core of our capital asset allocation approach. The reason for this is that our clients are either drawing from their investments and need to preserve their purchasing power for future years, or they are looking to maximise their returns over the longer term after inflation; either way, beating inflation consistently is the true objective of any investor.

In many instances small incremental real gains add up to meaningful returns over time whilst a ‘large’ gain from an investment which a friend or colleague held which you did not, creates the illusion that you are missing out. In reality this ‘large’ gain was probably preceded by or followed by a ‘large’ loss. History shows that positive real returns are very hard to generate without a clear plan and strategy. This is just one of the reasons our strategies have beaten their real return targets since inception whilst many of our peers (and their clients) have not.