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The Pound in Your Pocket

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Some of our older readers may remember the Sterling crisis of 1967 and the accompanying black and white footage of Harold Wilson, then Prime Minister, explaining to the British public that this did not mean that the “Pound in your pocket or purse, or in your bank, has been devalued.”

Ted Heath noted that this would be remembered as “The most dishonest statement ever made” whilst the Times thundered, “It means a reduction in this country’s living standards.” And, of course, Heath and the Times were right, it was a blatant lie. It also foreshadowed the long decline in the value of the Pound and the seemingly unstoppable rise in inflation throughout the 1970s.

Inflation has rightly been described as a “stealth tax.” You may also have come across the phrase “fiscal drag” as more people are drawn into the tax net by the simple trick of freezing allowances.

Politicians, of all persuasions, can exploit this sleight of financial hand because the General Public have only a hazy understanding of the difference between “real” and “nominal” or “volume” and “value.”

To my grandmother, there was, indeed, no obvious change to her pound or shilling and she proceeded to the market as usual only gradually realising that over time the number of apples, potatoes and spare-ribs, that her pound put in her shopping bag was diminishing.

Real wealth is measured in the capacity to command resources and in the capacity to command a growing share of those resources over time.

Ultimately, as the Bank of England’s top economist, Huw Pill, put it last week, in a startling departure in public truth-telling, our purchasing power is constrained by what the economy can produce not by how much we are all paid:

“Somehow in the UK, someone needs to accept that they’re worse off and stop trying to maintain their real spending power by bidding up prices, whether through higher wages or passing energy costs on to customers.”

“What we’re facing now is that reluctance to accept that, yes, we’re all worse off and we all have to take our share; to try and pass that cost onto one of our compatriots and saying: “We’ll be alright, but they will have to take our share too.”

As investors, we are trying to protect, maintain and grow the “real” purchasing power of our clients’ wealth over time.

If you measure your wealth in pounds, shilling and pence, the fact that your £10,000 has become £10,200 at the end of the year through interest payments, may make you may feel “nominally” better off.

If, however, the cost of the goods you want to buy with that £10,000 has increased to £10,500, then you are “really” poorer. In fact, your £10,200 in December is only worth £9,714 in the previous January’s pounds.

If you think about investing for a moment; when you exchange a cash value for, let us say, a simple fund investing in UK shares you are converting a financial asset (of uncertain future real value) into a real asset (of uncertain nominal future value).

The difference is that over time, a firm’s output prices will reflect its input costs. Bluntly, product prices will rise thus protecting the real value of your capital. By owning shares, land, or property, you own your share of the productive capital of the economy.

In the long run and in aggregate, the price level does not matter to firms since margins are maintained by the difference in prices and input costs. This is why, we recommend that even the most risk-averse investor keeps up to a quarter of their wealth in equity or shares. The type of equity is important however as a company that cannot grow its income in line with inflation during periods such as this year is at a significant disadvantage to one that can: ultimately investors will reward those companies at the expense of others over the coming years.