The Money Illusion

Money illusion is the tendency of people to think of currency in nominal, rather than real, terms. The numerical or face value of money is mistaken for its purchasing power. Thus people may have an illusory picture of their wealth and income based on nominal dollar terms.

The phrase money illusion was first coined by Irving Fisher in his book stabilizing The Dollar. It was popularized by John Maynard Keynes and Irving Fisher in the early 20th century, in their book The Money Illusion.

The money illusion can influence economic behavior in several ways.

- People tend to think of their income and assets in nominal terms not realizing the erosive power of inflation on their purchasing power.
- Contracts are not indexed to inflation as frequently as one would expect.

For **example**: A 2% loss in the nominal value of portfolio with only a 2% increase in inflation is seen as worse than a portfolio which increases in nominal value by 1% when there is 5% inflation. This second scenario is seen in more positive terms, despite them both being basically equivalent.

The overview which I stated in the above few paragraphs roots the "money illusion" fallacy equating the face value of currency with the purchasing power of currency. A 50 dollar bill is a fiat currency and has no intrinsic value, it represents buying power, as it is backed by the US Government.

In one study by Dr. Ackert, professor of finance at Kennesaw State University, she found people base happiness around nominal values. She conducted a study in which 77% of respondents were happier if they are better off in nominal terms, even if in real terms their purchasing power decreased. She explained this result by stating: "Simply put, it's easier to think that way."

My concern for my clients is the purchasing power of their portfolio when they are in retirement. In very few instances do investment companies or brokers discuss performance in relation to the consumer price index, which is a measure of inflation. Not understanding purchasing power could be a grave mistake when you are in retirement for 20 or 30 years and a million dollars doesn't have a million dollars of purchasing power.

Many people use 3% as the long term inflation rate in the United States. To illustrate the purchasing power of money (currency) I've used the following example in previous articles.

If milk is currently four dollars a gallon and inflation runs 3% per year how much would a gallon of milk cost in 30 years?

The answer is $9.70 per gallon which is a gain of 240%. Thus if your investments went up 200 percent in those 30 years , you have not even up kept up with inflation and thus you have lost purchasing power.

Let's say your initial investment portfolio is a one million dollar portfolio, over a 30 year period of time it has grown and is worth two million dollars in nominal value. You are probably thinking, two million dollars, that's a lot of money. However back to our example of the money illusion, the portfolio is really worth about 1.7 million in purchasing power and not the 2.4 million dollars you need to be at parity with your initial investment.

So the next time you sit down with your investment advisor and look over your investment policy statement which discusses how they will invest your money given a certain amount of risk among other variables, don't worry as much about beating stock or bond benchmarks worry about beating the CPI, (consumer price index).

My next article will discuss other types of money illusion which are used by companies on Wall Street to make it difficult for you to understand the ACTUAL performance of your portfolio.

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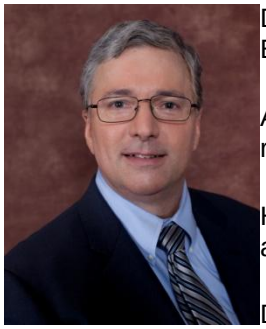

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After college he spent 3 years in the pharmaceutical industry and then went on to run and own several businesses including Handwerk Multi Family Office.

Handwerk Multi Family Office works with small business owners and families who are affluent. Over 50% of his family office clients are physicians.

Derrick is available to speak at regional or national events and many of the articles he publishes are a result of questions or issues sent in by readers via email. Please email financial questions or requests for speaking engagements to derrick@handwerkmfo.com.

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