Time to put a ceiling on our money illusions

By Stuart Fowler

There is no opt-out from the market in houses and financial assets. What happens to prices affects us even if we spend rather than save or rent rather than buy. Prices tell us about the past and about what lies ahead, in terms of risks to our future incomes and limits to our capacity to generate or preserve wealth.

There is no shortage of headline information about prices, such as monthly indices of house prices and the general rate of inflation, or the daily movement of stock market indices. But to be of any real use the prices must be in real terms, adjusted for general price inflation.

A measure of asset prices that has not been adjusted for inflation contains no more information about what has really happened than if the same index had been expressed in Turkish lire. Not looking at money amounts in terms of constant buying power is called money illusion.

With the UK's experience of changing states of inflation, examples of this are everywhere. They range from the massive destruction of middle-class real wealth by inflation in the two decades up to 1974 to the more recent shortfalls in mortgage endowments and the collapse of Equitable Life - caused by actuaries' failure to anticipate that inflation might fall again.

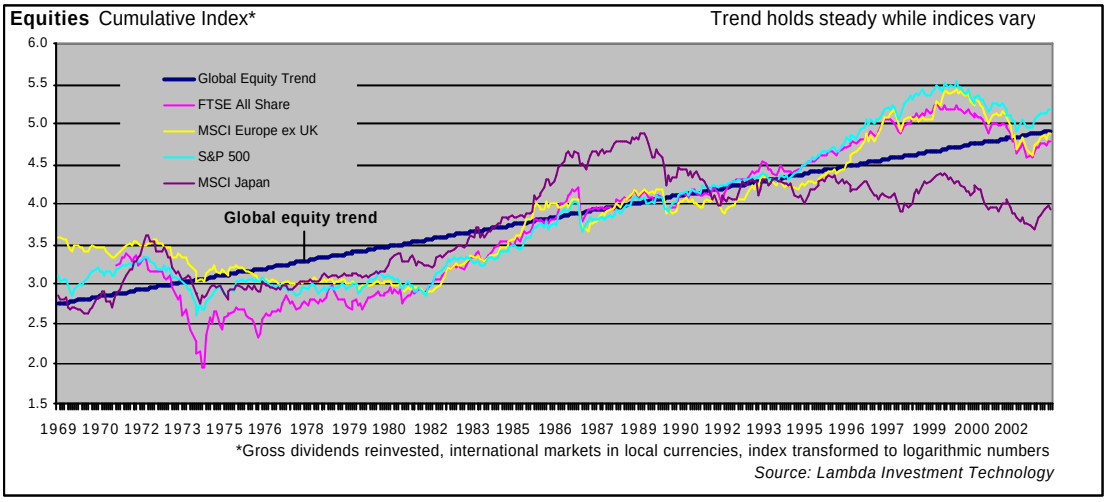
Money illusion has been recognised in many areas of public policy, hence the indexation of capital gains, tax thresholds and benefits. Yet nominal prices remain common currency in many areas of personal finance such as the nominal illustrated growth rates prescribed by the Financial Services Authority for all packaged investment products and the failure to educate people about the need for inflation-proofing of pension incomes.

It persists in measures of past asset prices, including those for houses, which we might expect to track most closely the general level of inflation. Real prices tell a more truthful story, but the correct measure varies among owners. For owner occupiers, it is the behaviour of real house prices. But for investors, it is real total returns, measuring capital change and income generated, that hold the truth.

The graph shows real total returns for each big equity market as a cumulative index with gross dividends reinvested for the UK, the rest of Europe, the US and Japan. The international markets are in local currencies. There has been one further transformation, to log numbers, which ensures that movements of equivalent size are proportionally equal. This avoids the false impression that a series with an upward trend is getting stronger or that variations are becoming larger.

The four indices have been fitted by Lambda Investment Technology to a common real total return trend for global equities of 6.3 per cent a year. This was estimated from the longest available data histories - between 60 and 180 years.

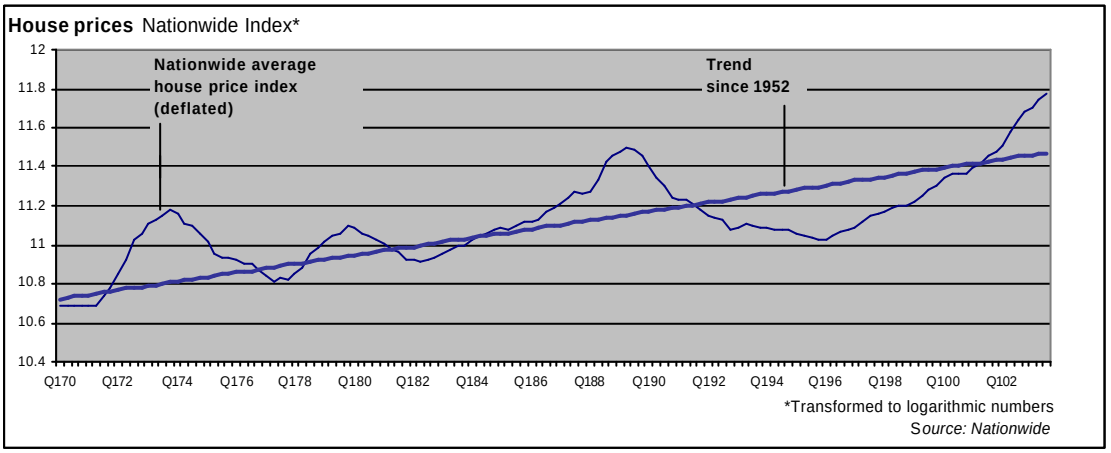
The distribution or variance structure for returns is surprisingly similar among countries and for the same country at different stages of development. Growth observations over any long period vary inconsistently between markets, but Lambda believes the best explanation is a common underlying trend. It has used statistical techniques to calibrate the shorter period of history shown here to the long-term trend.



This is an imprecise science, but the story told by past returns need not be greatly affected by estimation error.

We can see that the cycles around the trend are often large and may last for years. The extent of deviations is not predictable, however. What came to be seen as bubbles in Japan in 1989 and the US in 2000, with peak levels more than twice the trend level, are more extreme forms of the cycle. Peak-to-trough real losses have several times exceeded 75 per cent, but have always created the opportunity to earn high long-term returns.

The Nationwide index of real house prices has behaved much like equities since the 1960s. It calculates the growth trend since the start of the series in 1952 (to which this shorter history is fitted) as just 2.3 per cent a year. It is about the same as the equity return excluding dividends.



One reason for the low growth is that the index adjusts for changes in the average standard of housing. It is like an internal return, allowing for the investment of additional capital.

We should expect to double our original real investment every 25 years on improvements. Peak-to-trough falls in these real prices have in the past reached 40 per cent. The rise from the last trough to date is 110 per cent, much higher than the rise in real equity prices, without dividends, in past equity bull markets.

None of these graphical histories tells us what will happen next. But they tell us what might happen, which is worth more than what one expert thinks will happen. That humbling lesson is what history will teach us.

With such knowledge of history, would we have reacted as we did to the advances of late 1990s equity markets? Can we now view the property ladder as anything but precariously perched? The choice is to ride our luck or do something about it.

What can the concept of real returns do for me?

Can I tell anything about my house, my shares, from the market as a whole?

Not everything but a lot. Our home and our individual equity holdings struggle to avoid the impact of tidal movements in markets, during a cycle and (possibly more so) over longer periods. The reasons for doing better or worse usually turn out to be less predictable than we thought at the time.

Why the rule of thumb that equities are safe if you can hold for 5 years?

Money illusion is a big reason but no excuse. Past experience shows that in real terms it can take 10 years or more to see a high purchasing price again. That is true for property as well as stocks. Be careful of woolly flannel like 'medium' or 'long': time horizons should have dates and upside and downside should have numbers.

Do fixed income bonds show the same sort of behaviour?

Yes and no. Real return paths and outcomes for fixed income are much more affected by the state of inflation than for equities or property. Bonds that have no inflation indexation are dangerous: their behaviour can change from tame to wild. Mixing conventional bonds and equities in a 'balanced' strategy may possibly smooth the path of returns but does nothing to shrink the true range of real outcomes, just lowering it relative to equities or property.

Why the obsession with getting a foot on the property ladder?

The belief that house prices rise faster than they do is explained by money illusion, mistaking a phase of a cycle for a sustainable trend and not counting the investment in improving the real value of our homes. But the reason we think houses are such an easy way to build wealth is that high borrowing turned price growth into very high net equity growth. But high borrowing can also turn it into negative equity along the way and into a higher real cost than renting over the long term.

Are homes really under-taxed?

If (like other assets) only the real growth in capital were taxed, a trend of about 2% suggests houses are only favoured in times of boom. Since our home is usually the largest part of our estate, it will get hit for IHT: tax deferred but not avoided.

Can we all turn our homes into pension income?

This is a hoped for solution for the 'savings gap'. Trading down should be part of the demographic dynamics of the housing market, just like drawing down equity savings.

But after a housing boom, the rush to the exit will not let everyone who is planning to do this in the next 5 to 10 years achieve the price they now take for granted.

How relevant is Japan's experience?

Very. Japan has suffered a vicious combination of falling equity and property prices, crushing consumer confidence, piling up banks' bad loans and so making it difficult for the authorities to stimulate demand. Both America and the UK have enjoyed a bigger than usual house price rise, whether we call it cycle, boom or bubble, so a heavy fall in house prices is likely. No major equity market except Japan is so low as to be at all confident of avoiding further falls. So the same generalised deflation of asset prices and confidence might not be avoided. With much lower household savings than the Japanese, the impact on living standards could be dire.

Can you predict future real returns from the past?

Yes, unless you think the real return trends and cycles observed for different markets over nearly two hundred years are random and coincidental, rather than the result of reversion to a mean. Even actuaries, who model markets using assumptions of mean returns and variances, do not all accept mean reversion and rarely model equities directly in real terms. They work back to equities from gilt yields, though the link is too loose and unstable to distinguish real equity market conditions effectively. Their models projected long term real equity growth at the same rate when markets were exceptionally high as they did normally. Pension trustees should be incensed at being asked to stump up more money now that equities have fallen: it should have been in the model.