

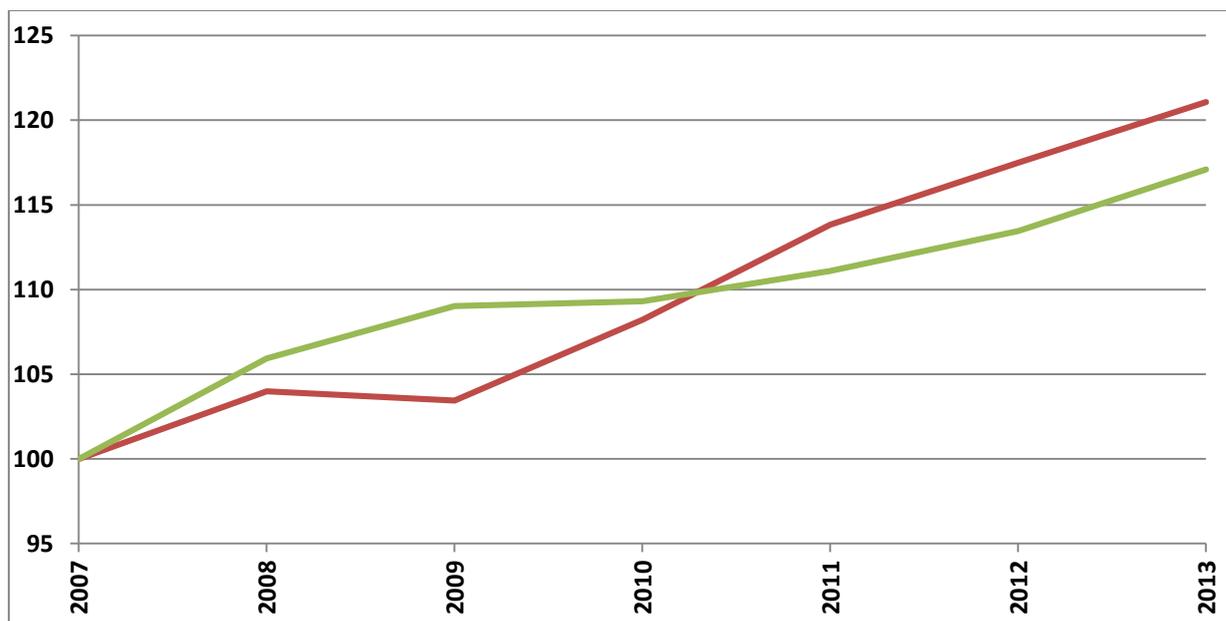
## Money Illusion – keeping it ‘real’

Money illusion is when we ignore the impact of inflation on our incomes, profits and investments. All too often we look at our financial well-being in headline or nominal terms rather in ‘real’ terms (net of inflation) which is what matters. Inflation matters because it informs us what we need to do in maintaining our living standards. If your incomes, profits and investments are unable to keep pace with inflation your financial well-being is deteriorating.

I have presented to over 1,200 sixth form students about money and finance and always mention money illusion. I use chart 1 to set out why it is important to take into account inflation and also introduce the impact of taxes and national insurance. I use the Retail Price Index (RPI) as my preferred measure of inflation as it is more aligned with our expenditure and usually higher than the Consumer Price Index (CPI) that is monitored by the Bank of England.

Chart 1 shows how take home pay, income after taxes and national insurance (green line) has grown between 2007 and 2013. The red line shows where take home pay would have been had it kept pace with inflation. As one can observe, actual take home pay has lagged in inflation adjusted terms. Ironically, while actual take home pay has risen it can create money illusion; the illusion misleads about the deterioration in real take home pay. Hence for people to feel better off after inflation, take home pay needs rise to a level to compensate for the period when real take home pay declined, otherwise the illusion is perpetuated.

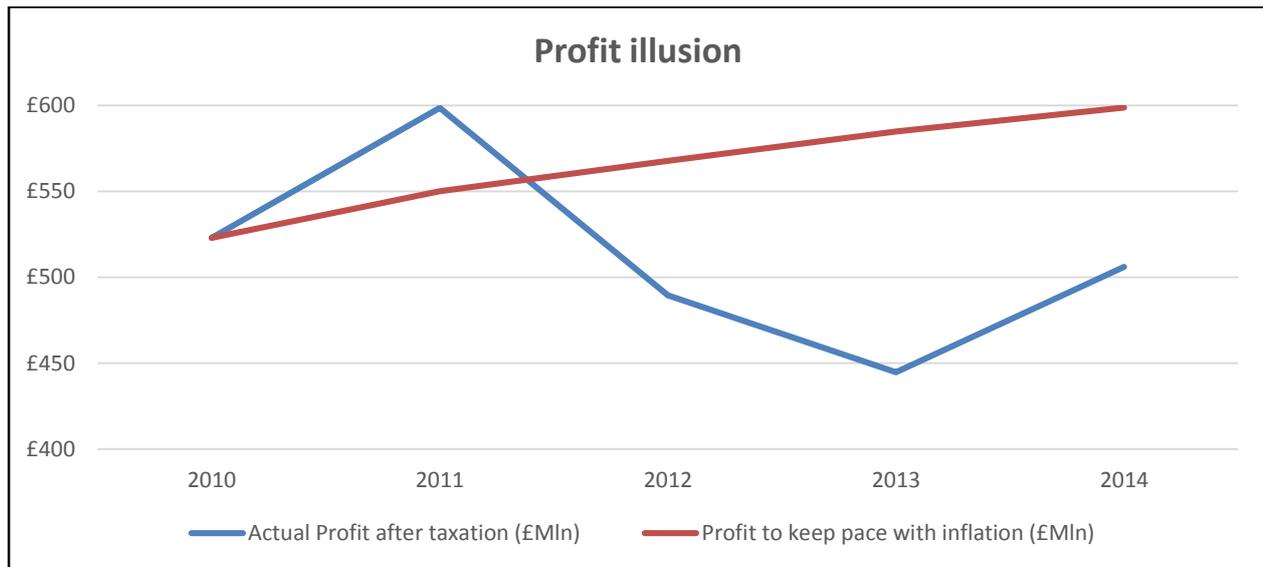
**Chart 1 – Median take home pay 2007-2013 –real (red line) vs actual (green line)**



Source: ONS, Financial Architecture

Business owners/managers also need to be aware of money illusion or rather profit illusion. Chart 2 shows how a large UK retailer's profits have not kept up with inflation even though it generated £506 Mln profits after tax in 2014. Large nominal profits are comforting but not as meaningful as large real profits. This large UK retailer's actual profits are £100Mln below where they should be when taking into account the impact of inflation. Declining profits in real terms reduces the resources available to invest in the business, retain and attract talent and maintain the business' competitive advantage.

**Chart 2 Profit illusion - a large UK retailer**



Source: Large UK retailer, Financial Architecture, ONS

Even with current inflation at low levels, the cumulative effect of inflation cannot be underestimated as it is a relentless factor that erodes the value of your incomes, profits and investments. Hence, whether you are in employment, run your business or investing your savings you need to ensure that you are not succumbing to money illusion. Otherwise, you will always be puzzled as to why you are expending so much effort for very little reward or progress. In the words of Iris Murdoch -

*“We live in a fantasy world, a world of illusion. The great task in life is to find reality.”*

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