Turning Inflation Into Wealth Mini-Course

Reading Four:

Piercing The Illusion Of The Nominal

This Reading Is Exclusive To This Course

MortgageSecretPower.com

The first and perhaps most crucial step in distinguishing inflation victims from inflation beneficiaries is one of **vision**. If you are blind to what is really happening around you – then you will likely be a victim. When you fully see what is happening, particularly if you can learn look at the same situation from several perspectives simultaneously – then you uncover both dangers and opportunities that most of the people around you will miss.

In today's reading we return to the subject of our unconventional morality play, with our virtuous and debt-free hero, Peter, as well as the nefarious pickpocket Scott. We will start by changing our perspective and looking at the situation from Peter's viewpoint. Peter sees the world in nominal terms – like almost all of us do, on a day to day basis. Remember nominal simply means that a dollar is a dollar, and there is no adjustment for inflation.

As you will see on the next page, we've changed some of the numbers around a bit, to help illustrate some of the principles in today's reading and the readings to follow. We now start off with Peter having $100 in assets, and Scott only having $10 in assets. So Peter now starts off with 10 times the assets that Scott has (91% of the wealth compared to 9.1%). Peter still loans his $100 to Scott, and Scott now uses his entire $110 ($10 in net worth and a $100 loan) to buy a tangible asset. It could be an apartment building or precious metals, or even something overseas, but for today we will call it a house. A powerful inflation sweeps through the economy, and the dollar loses 90% of its value. What used to cost ten cents, now costs a dollar.

This is a good place to stop, and check our vision. Look very carefully at Scott, before and after. He experienced a huge increase in personal wealth, both in general and also relative to Peter. Where did the money come from? Was it the asset, the liability, or both?

Inflation Pickpocket

Exhibit 1A: 2 People, Nominal Dollars
Before

	Starting Assets	Starting Debt	Starting Net Worth	Starting Share of G & S
Peter	100	0	100	91%
Scott	110	100	10	9%
Total	210	100	110	100%

Nominal Results (No Inflation Adjustment)
After 90% Loss in Value of Dollar

	Ending Assets	Ending Debt	Ending Net Worth	Ending Share of G & S
Peter	100	0	100	9%
Scott	1,100	100	1,000	91%
Total	1,200	100	1,100	100%

G & S = Goods & Services

When we look at the situation after the inflation, as far as Peter is concerned, he didn't lose a dime on his investment, and Scott didn't take anything from him, as Peter was eventually repaid in full. Peter also made some interest earnings – as Scott made some interest payments – but we will leave these out for now, to keep things as simple as possible. (When we do include interest payments, and their tax implications in later readings, the results just may surprise you.)

Yes, Peter did lose 90% of the purchasing power of his assets, but that was just because the world worked out the way it did. The same thing happened to most of his friends, and to their IRAs and Keoghs as well. The headlines have been full of the news of what happened for years, and Peter has a lot of company in earning extra money by working in a fast food restaurant in retirement – because a lot of people's long term investments didn't quite work they planned, when the time came for everyone to cash out paper wealth into real goods and services.

When Peter looks at the Scott, and the much higher standard of living that Scott is now enjoying – Peter is looking with wistful admiration rather than anger. Peter knows that Scott made an outstanding investment choice – a choice that was so good that Scott made a 900% return on investment. Peter can only shake his head and wish he had been an investment genius like Scott. For, as can be obviously seen in the chart above, the loan was a wash, and had nothing to do with their reversal in financial status, it was all about the assets.

Scott sees the world in nominal dollars, just like Peter does. But, Scott also knows how to see the world in terms of not just dollars – but what dollars will purchase. When Scott looks in terms of real wealth, this is the situation which he sees:

Inflation Pickpocket

Exhibit 1B: 2 People, Real Dollars
Before

	Starting Assets	Starting Debt	Starting Net Worth	Starting Share of G & S
Peter	100	0	100	91%
Scott	110	100	10	9%
Total	210	100	110	100%

Real Results (Adjusted for Inflation)
After 90% Loss in Value of Dollar

	Ending Assets	Ending Debt	Ending Net Worth	Ending Share of G & S
Peter	10	0	10	9%
Scott	110	10	100	91%
Total	120	10	110	100%

G & S = Goods & Services

From Scott's perspective – he is no investment genius. All he did was find a place to hold on, where his assets could withstand a plunge in the value of the dollar without loss. In terms of relative purchasing power, the house was worth $110 before inflation, and in real dollars, the house was still worth $110 after the inflation.

Using the same perspective we used in the previous reading, we can see that in real dollars, Peter's net worth has fallen from $100 to $10, as his $100 loan asset is only worth $10 after adjusting for inflation. The value of Scott's debt has fallen to only $10. So Scott now has a net worth of $100, which is equal to exactly ten times Peter's after-inflation net worth of $10. There was a $90 change in the value of the loan, where Peter lost 90% of his net worth, and Scott used inflation to take that net worth from Peter and increase his own net worth by 900%. From the perspective of real dollars, the wealth transfer is all about the debt.

Which perspective is correct?

Let's take a look at several answers. A good place to start is to carefully compare the exhibits for real dollars and nominal dollars and look for where the differences are. The first three columns appear to differ radically when we go from real dollars to nominal dollars in the different charts. Peter's losses disappear, and Scott appears to have made an enormous profit.

	Real Dollars			**Nominal Dollars**		
	Ending Assets	Ending Debt	Ending Net Worth	Ending Assets	Ending Debt	Ending Net Worth
Peter	10	0	10	100	0	100
Scott	110	10	100	1,100	100	1,000
Total	120	10	110	1,200	100	1,100

However, if our goal is not dollars, but what dollars will buy us, then we need to focus on the rightmost columns which tell us the share of the rights to goods and services that our dollars will buy for us. Those columns are identical. Doesn't matter whether we use nominal dollars or real dollars, where it truly matters, the ending bottom line is identical between the two exhibits – Peter and Scott reverse positions, with Peter dropping from 91% of the real wealth down to 9%, even as Scott neatly captures that real wealth in rising from 9% up to 91%.

	Real Dollars	**Nominal $**
	Ending Share of G & S	Ending Share of G & S
Peter	9%	9%
Scott	91%	91%
Total	100%	100%

The only way that Peter's perspective is correct, is if we accept that the value of a dollar is fixed. Is it? Let's take a quick look at the chart below, which tracks changes in the value of a dollar over time. Hopefully the chart is fairly self-explanatory. Who do you think is doing a better job of "seeing" financial reality?

Seeing The Value Of A Dollar

(1) Year	(2) Average CPI	(3) Annual Inflation	(4) 1972 Dollar Value	(5) **Value of A Dollar -- What Peter Sees**	(6) **Value of A Dollar -- What Scott Sees**
	40.5				
1972	41.8	3.2%	$1.000	**$1.00**	**$1.00**
1973	44.4	6.2%	$0.941	**$1.00**	**$0.94**
1974	49.3	11.0%	$0.848	**$1.00**	**$0.85**
1975	53.8	9.1%	$0.777	**$1.00**	**$0.78**
1976	56.9	5.8%	$0.735	**$1.00**	**$0.73**
1977	60.6	6.5%	$0.690	**$1.00**	**$0.69**
1978	65.2	7.6%	$0.641	**$1.00**	**$0.64**
1979	72.6	11.3%	$0.576	**$1.00**	**$0.58**
1980	82.4	13.5%	$0.507	**$1.00**	**$0.51**
1981	90.9	10.3%	$0.460	**$1.00**	**$0.46**
1982	96.5	6.2%	$0.433	**$1.00**	**$0.43**
1983	99.6	3.2%	$0.420	**$1.00**	**$0.42**
1984	103.9	4.3%	$0.402	**$1.00**	**$0.40**
1985	107.6	3.6%	$0.388	**$1.00**	**$0.39**
1986	109.6	1.9%	$0.381	**$1.00**	**$0.38**
1987	113.6	3.6%	$0.368	**$1.00**	**$0.37**
1988	118.3	4.1%	$0.353	**$1.00**	**$0.35**
1989	124.0	4.8%	$0.337	**$1.00**	**$0.34**
1990	130.7	5.4%	$0.320	**$1.00**	**$0.32**
1991	136.2	4.2%	$0.307	**$1.00**	**$0.31**
1992	140.3	3.0%	$0.298	**$1.00**	**$0.30**
1993	144.5	3.0%	$0.289	**$1.00**	**$0.29**
1994	148.2	2.6%	$0.282	**$1.00**	**$0.28**
1995	152.4	2.8%	$0.274	**$1.00**	**$0.27**
1996	156.9	3.0%	$0.266	**$1.00**	**$0.27**
1997	160.5	2.3%	$0.260	**$1.00**	**$0.26**
1998	163.0	1.6%	$0.256	**$1.00**	**$0.26**
1999	166.6	2.2%	$0.251	**$1.00**	**$0.25**
2000	172.2	3.4%	$0.243	**$1.00**	**$0.24**
2001	177.1	2.8%	$0.236	**$1.00**	**$0.24**

The dollar has of course changed every year of our lives, <u>a dollar has never been a dollar</u> – not when we compare dollars between different years. And when we take the nominal dollars and great investment that Scott made, and we adjust for the central assumption of our little tale, which is a dollar becoming worth ten cents – then the illusion disappears. We divide by ten, the differences disappear, and we are left with Scott having quite directly taken 90% of Peter's net worth through the loan.

Matters Of Vision

There are going to be a few readers for whom this reading may seem repetitive of what has already been covered in the first reading, "Inflation Pickpcket". When they reached the nominal value summary on page 3, these readers were never diverted by the extraordinary and distracting surge of dollar value for Scott's asset value, as it leaped from 110 up to 1,100. They did a quick mental division by 10, instantly pierced the illusion, moved past the illusory asset profits to focus on that liability staying at 100 both before and after the inflation, and then yelled "pickpocket!" If that was your response – then congratulations, you are an economically astute individual who easily grasps the difference between nominal and real and effortlessly flips back and forth. Don't worry, we are only starting here, there will be lots more to come as we leave the basics behind in other readings.

Then – there's the rest of us. What did you see? Did you know you were supposed to look to the real, but found it difficult to get past the nominal: Scott becoming wealthy through buying the right asset? That movement in asset value from 110 up to 1,100 does look awfully convincing, in terms of where the wealth came from. Why isn't it as simple as it looks: Scott bought a house that jumped in value, his debt stayed the same, and he made his money off the house?

For many readers, you may even be having trouble completely accepting what we've reviewed in this first few readings. For good reason! After all, **the nominal is reality** for most people. What Peter sees is what we all see. It is what is reported daily in the newspapers, including the financial newspapers. Every time you read about a new stock market high – you are looking at the world through Peter's eyes. Every time you read about a real estate tycoon making another fortune – it is being presented through Peter's eyes. Even when you sit down with your financial planner, the future will likely be presented through Peter's eyes – and while there may be a footnote for Scott and inflation, it will likely not be a comprehensive footnote detailing the combination of assets and liabilities that will determine your real inflation-adjusted net worth.

Applications

If you wish, it may be worth printing out page 3 by itself, which is Peter's view of what happened, and using it as a "vision" exercise. Look at after a few hours, or look again tomorrow, without all these supporting materials. What do you see? In our reading, "Inflation Pickpocket", we practiced looking at the real. This application is about learning to look past the nominal and see the real. This is a more difficult task –and also the real world task required to practically apply these principles. Without that vision you may have pre-selected your status in an inflationary environment, and that is the status of being Peter – the victim.

Unfortunately, we likely have a very bad time coming up for people who can't see past the nominal. We have promised more dollars than there is wealth available for Boomer retirees. The simple and necessary way to reconcile this problem is to increase the number of dollars. There is another name for dollars increasing faster than real wealth – it is the definition of inflation. Basic economics shows that inflation <u>generally</u> redistributes wealth from investors and retirees to debtors and current workers. Meaning the very act of retirement for the Boomers is likely to create a powerful surge in inflation that will devastate the value of the retirement savings of the Boomers – and the investment portfolios of non-Boomers as well.

Fortunately, unlike most people – you are taking steps to actively protect yourself from this danger, by taking ten to fifteen minutes every few days for this course. Your first line of defense is your vision, and we will take another step with theory and story to further improving your vision in the next reading. We are going to explore the answers to today's questions through the simple measure of using a "control". We are going to introduce a tangible asset only investor, to take a look at how much of the increase in net worth truly does come from buying the right asset – and how much comes from being short the dollar in the form of just the right debt.

Then, starting in Reading Six, you are going to begin to reap your rewards, by effortlessly seeing something that most people don't. We are going to go to visit one of the greatest transfers of wealth in American history – and show you what really happened. Something that most of the people who benefited from this transfer never saw and still don't understand today – because they only see the nominal.

If A Link To This Reading Was Given By A Friend

If you found this article because of a friend's recommendation, then you should know that it is the fourth reading in a free mini-course on Turning Inflation Into Wealth. Much more information on the course and the benefits of the course to you are available by following the link below.

http://mortgagesecretpower.com/Mini%20CourseB.htm