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Government's definition of 'savings' not accurate reflection of net worth

BY FRANK GOODMAN

Back when I was a young graduate student, I was taught that the stock market was "efficient" and that it could not be beaten over the long run.

I liked that theory. It greatly reduced the importance of experience and, therefore, the knowledge gained from experience. So, as a fresh MBA, that suited me just fine.

Of course, I subsequently have learned – through experience – that the definition of "efficient" wasn't that the market is always right, but rather that it reflects the collective knowledge of all the market's participants at any one time. By January 2001 it also had become obvious to me that, sometimes, what everyone knows at any one time is wrong.

In fact, I'm now aware that market history is full of participants knowing things that are wrong at any one time.

Wrong is something the stock market can be in many ways. The price of a stock is just the opinion of the people who want to sell that stock relative to the opinion of the people who want to buy that stock, at that moment. It is a dollar-denominated opinion of that company's future, at that moment.

Therefore, it turns out that the market's "efficiency" actually creates opportunities to beat the market. The keys are: a) knowing when the market is wrong about something, and, b) having the liquidity to last until the truth outs.

Let's look at a current example of the media blanketing everyone with some common knowledge that is all wrong: That the household "savings rate" in America has plummeted and is dangerously low.

NIPA (National Income and Product Accounts) accounting was created in the 1930s as a tool to help the government understand and influence the economy. Under NIPA, household "savings" are defined as that which is left over after consumption is subtracted from income. Makes sense, as long as what's measured as consumption is consumed. But what happens when consumption includes spending on things that are long-lived appreciating assets? Does there not become a mismatch between households creating actual net worth and those where the idea persists that "savings" – and therefore accumulated net worth – simply equal income minus consumption.

I am sure, astute reader that you are, you have caught on that there is indeed a substantial mismatch. What is even more interesting is that "household savings" is being pressured downward by the action of many different actors, not just households.

From households, the downward pressures include the fact that a down payment on a home is regarded as consumption that reduces savings. Money spent on continuing education also is counted as consumption. Switching to a 15-year mortgage increases consumption and also is bad for "savings" – despite the substantial real savings in interest expense. Also, believe it or not, putting money in a tax-deferred 529 college savings plan is counted as consumption.

Employers also have been and will continue to be a major source of reduced household savings under NIPA. Companies that switch from a defined benefit to a defined contribution pension will reduce your "savings." An employer's contribution to your 401k is both income and consumption, which, mathematically, reduces "savings" as a percentage of income.

Lastly, the government itself is a substantial source of the reduction in household "savings." The biggest example is that Social Security contributions are regarded as consumption.

The last bipartisan committee that saved Social Security (headed by Alan Greenspan) accomplished this miracle by causing the threshold on income subject to Social Security tax to go up across time. As that threshold goes up, "savings" goes down. Of course, this change increases the likelihood that Social Security will pay out 100% of benefits, which improves the prospects for households who didn't or couldn't create adequate net worth. But, this is bad for "savings".

How do you expect people to act? Do you expect them to behave rationally toward improving their net worth, or to "save"? The research clearly shows that as net worth has gone up in America, the rate of "savings" has gone down.

So, it turns out that the dangerously low "savings" level in America actually is irrelevant to everyone but the bankers who depend on savings deposits.

Therefore, the question: "Does this fixation on a broken statistic affect prices in the market?"

The answer is if everybody believes something that is wrong, then the price is wrong.

That's "efficiency".