Letter to the Editor – The Hedonic Pleasure Index™

December 16, 2008

Dear Editor:

James A. Shambo's paper, "*The Hedonic Pleasure IndexTM - An Enhanced Model for Spending Inflation,"* does reflect information in the recent BLS report, which summarily dispels several myths about the BLS-produced CPI indexes. Mr. Shambo perpetuates these myths in his paper, although that's probably because the BLS report wasn't available when he submitted his paper. In any case, his anti-CPI position is substantially invalid.

Bob Bronson
Bronson Capital Markets Research
Denver, CO

Jim Shambo responds:

Mr. Bronson suggests my paper is substantially invalid because I perpetuate myths about the BLS-produced CPI indexes, citing a recently published paper "Addressing misconceptions about the Consumer Price Index" by Messrs Greenlees and McCelland in the August 2008 Monthly Review. Let's be clear the target of this paper is not the "Hedonic Pleasure Index™" but rather critics of the construction of CPI, who claim it is understated by 7% or more.

Price indexes are constructed by the government to assist them in making macro-economic decisions. My paper does not challenge their methodology or their motives. Personal consumption and consumption growth, on the other hand, is a function of individual client behavior. My paper concludes that consumption growth is influenced not only by price changes but also by:

- Clients' wage growth or contraction;
- Clients' asset growth or contraction;
- Credit growth or contraction for both the individual and the economy as a whole;
- Changes in consumption behavior; and
- Changes in the economic climate

My paper further concludes that the level of individual consumption is a function, not only of the cost of the products purchased, but:

- Changes in product quantities purchased;
- Changes in the quality of products purchased; and
- Changes in attitudes toward spending

Table 1 below is an example of changing consumption behavior taken from the Pew Research Center's "A Social Trends Report." These consumption changes are evidence of a credit driven, instant gratification mentality and have nothing to do with the price index.

Table 1: Changing Consumption Behavior

Consumer Item	Necessity in 1996	Necessity in 2006	% Increase
Microwave	32%	68%	113%
Home Computer	26%	51%	96%
Dishwasher	13%	35%	169%
Cable or Sat TV	17%	33%	94%
Cell Phone	N/A	49%	N/A
High Speed Internet	N/A	29%	N/A

Consumption is personal; it is not a sterile price index. All the evidence on the planet shows that Americans want to improve, not maintain their standard of living, which is what a price index measures. I parse out the changes to the CPI because they assume a certain behavior that may well capture the information needed for policy makers constructing a price index, but are inappropriate for our clients' constructing their own consumption growth index. The BLS created the CPI-U RS (Research Series) to measure the impact to CPI assuming certain consumer behavior. Far from challenging the BLS conclusions, I adopted them when I created the "Build-Up Method" in my paper.

Every one of our clients is unique and each has dramatically different consumption patterns. Some clip coupons and others buy what they like. Some follow exactly the pattern the BLS depicts (and substitute goods as prices vary) while others defy that logic. The price index cannot capture these individual patterns. My Hedonic Pleasure Index™ does not challenge how the price index is created; it evaluates the usefulness of the price index as a measure of consumption. My goal is to stimulate a discussion to explain any failures of the index to accurately reflect reality.

My favorite example of how a quality change is excluded from the price index, when it must be included in the consumption index, is in the automobile industry. Can you say to the car dealer, “Please remove the air bags, child safety restraints, catalytic converters, anti-lock braking system, rollover mitigation or electronic force distribution”? Can you choose to purchase only the parts of the car that “maintain your standard of living” or must you also buy the parts mandated by government regulations?

Or consider quality improvements in the home. When your refrigerator or washer quits do you tell your Sears salesperson to remove the energy efficient technology and the automatic features now standard on all models since your last purchase? Of course not. We accept price changes, quality changes and quantity changes as an integral part of our consumer behavior. Evidence is that each generation is paying for more of these price and quality changes than the previous generation.

My paper posed several questions: why do we assume everyone has the same consumption behavior, why do we consider only price changes and why do we use a standard measurement (i.e., the CPI) for the one factor in our simulations that models purely client-specific purchasing patterns? I found that per capita consumption growth reflects the behavioral aspects of consumption much more closely than the price index. I concluded that our responsibility is to reflect our clients “real world” when we simulate their needs. My goal is to create a transition for our profession from an “average price index” to an “individualized consumption index.” I hope my paper stimulates thinking and debate of client spending behavior within our profession, just as we have learned how to consider individual investing behavior.

James A. Shambo CPA/PFS
Lifetime Planning Concepts
Colorado Springs, CO