

Inflation Risk

What is inflation?

When you see the term “inflation” in the newspaper, it refers to a change in the Consumer Price Index (CPI), which tracks the costs of goods and services typically purchased by consumers. This government figure is good for measuring economic activity for the country at large, but does little for individuals who have buying habits based on their age, lifestyle, and where they live that are different from the typical consumer’s. If you spend a lot on goods and services with high inflation rates, such as college and medical expenses, the CPI significantly understates the impact that inflation is having on you.

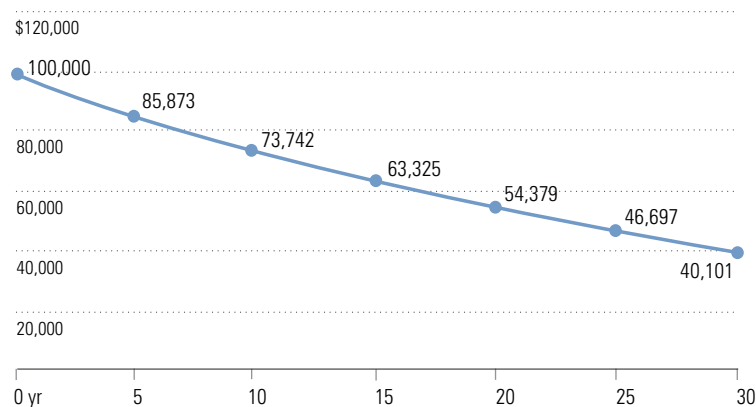
How does inflation erode purchasing power?

Most consumers don’t understand how damaging inflation can be over long periods of time on their purchasing power. One dollar today simply doesn’t buy as much as it did in 1970 and will buy even less 30 years from now. If you long for the days in which you could buy a Coke for a nickel, you know exactly what we’re talking about.

Inflation has averaged about 3% annually from 1926–2006. Three percent may not seem like much, but it can significantly erode your purchasing power over long time horizons. Take for example the impact a 3% inflation rate can have on a fixed annual income of \$100,000 over a typical 30-year retirement. As the image below demonstrates, your money would be worth 14% less in five years and in 30 years, the purchasing power of your income would be reduced by nearly 60% to \$40,101.

Inflation significantly erodes purchasing power over time

Effects of 3% inflation on purchasing power



There’s a good chance that the rate of inflation you will experience in retirement will exceed the long-term 3% average, simply because goods and services that you will be purchasing won’t resemble what the typical consumer is buying in the CPI aggregate. Medical expenses in particular are likely to be a significantly higher portion of your overall spending. A recent estimate from the Centers for Medicare & Medicaid Services suggests medical inflation may be as high as 6.3% annually over the period 2005–2015.¹

Questions to ask your advisor:

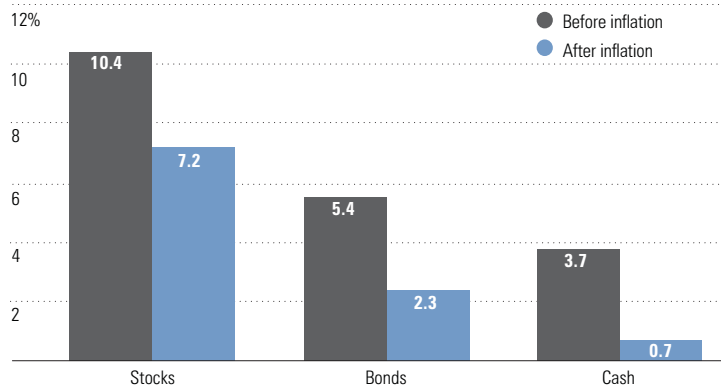
- ▶ Based on my age, lifestyle, where I live, and sources of income, what is the impact that inflation is having on my retirement savings?
- ▶ How should my investment assets be allocated to minimize inflation risk? What level of allocation to stocks is appropriate for me?
- ▶ What investments can help me offset my inflation risk, such as Treasury Inflation Protected Securities (TIPS) and financial products that have CPI-indexed features? Are such features worth the additional cost?

What asset classes keep pace with inflation over the long run?

Despite the risk inflation can pose to retirement savings, the natural tendency for many retirees is to protect their investment assets by investing conservatively. As a result, many retirees’ portfolios are largely allocated to bonds and cash with minimal exposure to stocks. History shows however, that of these three asset classes, stocks were the only one to provide significant growth after accounting for inflation.

Stocks provide growth to outpace inflation (CPI)²

Asset class compound annual returns before and after inflation 1926–2006



The graph above illustrates the average annual returns for stocks, bonds, and cash from 1926–2006, before and after inflation. Government bonds returned very little after inflation. Cash fared even worse. That said, you may be hard-pressed to meet income needs over a 30-year retirement if your portfolio is invested primarily in bonds and cash.

Given this, you should consider having some exposure to stocks. A long-term horizon can cushion the impact of short-term volatility and extra risk associated with stocks. The payoff for accepting this extra risk is a portfolio that has a better chance of keeping pace with inflation and protecting your purchasing power.

¹Source: Medical inflation estimate—National Health Expenditures per capita, Centers for Medicare & Medicaid Services, Office of the Actuary, U.S. Department of Health and Human Services.

²Keep in mind that an investment cannot be made directly in an index, and past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. The data assumes reinvestment of all income and does not account for taxes or transaction costs. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes.

Source: Stocks—Standard & Poor’s 500®, which is an unmanaged group of securities and considered to be representative of the stock market in general; Bonds—5-year U.S. Government Bond; Cash—30-day U.S. Treasury Bill; Inflation—Consumer Price Index.