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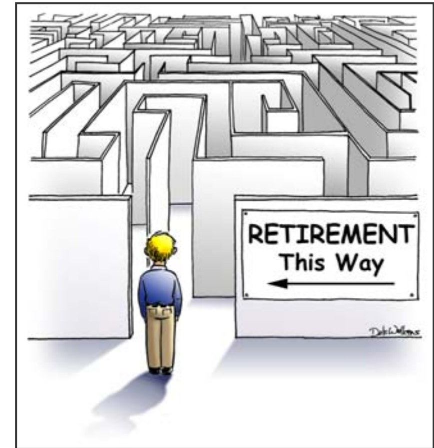
Inflation: The Stealth Enemy of Retirement

Navigating the Retirement Maze



In retirement planning, items considered mandatory include assets needed at retirement, asset mix over time, safe withdrawal rates, and health care coverage. A topic that isn't always considered, but should be, is inflation. A recent survey by the Society of Actuaries found that only 55% of retirees and 72% of pre-retirees are factoring inflation into their retirement planning process.

Since 1900, inflation has averaged around 3% per year, though it has been as high as 18%. The Federal Reserve recently forecast that inflation would come in around 2.5% this year. However, the U.S. Consumer Price Index (CPI) – the most commonly cited measure of inflation – excludes food and energy. (Try getting through a day without either of those.) Using the pre-1990 definition of the CPI that includes them, ShadowStats.com pegs inflation today at 8-10% per year.

The Inflation "Tax" On Investment Earnings

So what if inflation does end up averaging 5% annually over the next decade? Just like the compounding of investments results in higher returns, the "compounding" of inflation has a similar effect on prices. For example, if the price of a $1.00 hamburger increases at 3% per year, that same burger will cost $1.81 twenty years from now. If burger inflation is running at 5%, though, you'll pay $2.65, or 46% more, for that same burger in twenty years.

To reduce the chance of outliving your retirement savings, you need to factor inflation into your calculations. Thus, a portfolio return averaging 7% a year over the next decade would, with 5% inflation, have a "real return" of 2% per year, reflecting your reduced buying power. Your withdrawals would need to increase 5% each year to maintain your standard of living.

With Bonds, "Immaturity" Is Better

Some investments are better than others for inflation-proofing your portfolio. Let's start out with one that currently isn't: long-term bonds. There is a misconception that bonds are the ultimate safe investment. Their prices don't gyrate like those of stocks, and they provide a steady stream of income for the life of the bond, after which you receive your initial payment back.

The problem with long-term bonds is that you are locked in to an interest rate for the life of the bond, and if interest rates and inflation rise, you could find yourself effectively losing money if your yield is below the rate of inflation. As of this writing, 30-year U.S. Treasury Bonds return 4.75% per year. If the true inflation number today is on the order of 8%, then your "real return" is actually -3.25%. Ouch.

If you do invest in bonds, and most portfolios should have some bond exposure, stay with maturities of 2 years or less for now. Though the yields on shorter maturity bonds right now may be downright painful – 2-year corporate AA bonds are currently paying only 1.0% – if

interest rates rise, you will be able to roll these bonds into higher yielding ones in two years or less. At higher yields, longer maturity bonds will become more attractive.

Investments That Can Cope With Inflation

In times of rising inflation and interest rates, there are some investments that tend to grow at or above the rate of inflation. These include:

- REITs – Real estate investment trusts can often pass on higher costs to their tenants. Today, residential REITs seem a safer bet than commercial ones.
- Commodities – If increasing commodity prices are contributing to inflation, then put some in your portfolio. Skip the futures markets, and stick with mutual funds and ETFs that focus on commodity investing. There is a wide range of alternatives here, though, so do your homework.
- TIPS – Treasury Inflation Protected Securities are bonds that have some inflation protection built in. However, as the Government's definition of the "I" excludes energy and food, there isn't as much protection as their name implies.
- Energy MLPs – With energy a major component of the inflation equation, energy Master Limited Partnerships often do well in this environment.

As a side note, stocks generally behave well with moderate and steady inflation, but poorly in times of high inflation.

While no one can predict the future, we can learn from the past and extrapolate from the present. In assessing cash flow needs and investment mix for retirement, we need to factor inflation into the calculations.

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