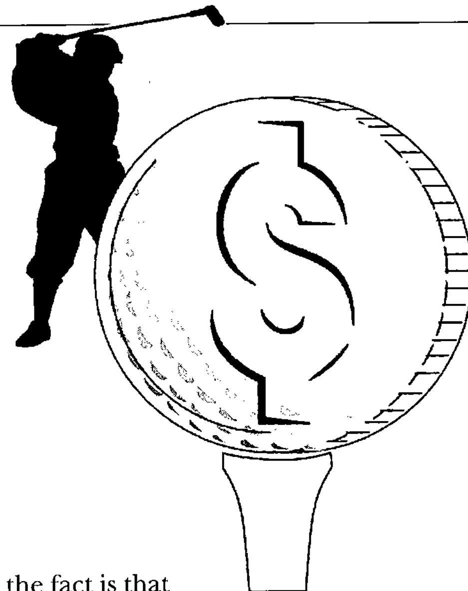
Inflation Alert For Retirees



Countering The Risks Of Inflation

Gordon Tiffany

Nobody likes inflation, but the fact is that it poses an especially severe problem for retirees. And while it is true that inflation has been at historically low levels of late, people should not be lulled into complacency. Retirees living on limited incomes will be particularly vulnerable to its effects, even if inflation rates seem relatively low today.

Why are retirees so sensitive to the impact of inflation? Largely because their incomes are more or less fixed and because they are intensive users of costly medical services. While about half of those participating in public pension funds receive cost-of-living adjustments (COLAs), few will receive adjustments for the full consumer price index (CPI). In addition, Social Security COLAs cannot be assumed with any confidence for the future.

In any plan to counter the risk of inflation, the first problem is to estimate its rate for the long term. It would be a mistake to base plans either on the double-digit inflation of the 1970s and 1980s or on the low rates of the last few years. (The CPI has reached double-digit levels in only four years since World War II: it reached 18.2 percent in 1946; 12.2 percent in 1974; 13.3 percent in 1979; and 12.4 percent in 1980. At the opposite end of the rate spectrum, inflation dipped to 1 percent for four years in a row during the early 1980s.)

Since 1926, however—through war and peace, Great Depression and postwar boom—inflation has averaged just over 3 percent. Over the last 35 of those years, inflation often has been higher, averaging 4.8 percent. Since

1991, we have seen somewhat lower rates, from 3.1 percent in 1991 to last year's 2.6 percent. Given this evidence, planning for inflation in the range of 3 percent to 4.5 percent seems reasonable.

It would be tempting to assume that we can manage spending to accommodate such minimal annual price increases. Over the long term, however, even low inflation rates will erode living standards. If prices increase an average of just 3 percent annually, it will take only 25 years to cut the purchasing power of a dollar in half; at 4 percent, a mere 18 years. This means that if an individual's retirement lasts 20 years, he or she will need about twice the income in the 20th year as in the first year just to stay even. Translation: Ignoring inflation in retirement planning could cost dearly.

Because people cannot control the CPI and cannot influence COLAs for their pensions or Social Security, how can they protect themselves from inflation in their retirement plans? The best answer is, through the thoughtful management of investments.

Deferring Taxes to Beat Inflation

The tax code gives most of us ample opportunities to put money away for the future and to make that money work hard enough for us to overcome inflation and provide a comfortable retirement. Opportunities come in the form of various defined-contribution retirement plans: 401(k) and 401(a) qualified plans and 457 deferred compensation plans. Tax-deferred savings plans provide the most powerful inflation-fighting weapons available. Tax brackets today range from 15 percent to 28 percent or higher, so using fully tax-deferred retirement savings offers a big advantage over conventional savings.

Investing to beat inflation today means putting at least some money into stocks.

Investing to Beat the Retiree's Enemy

How savings are invested also will make a big difference when a person is ready to retire. When inflation was low, a passbook account was a reasonable investment. A passbook account paying 2.5 percent in 1955 had a real return of over 2 percent. In 1979, however, with inflation skyrocketing past 11 percent, an investment had to pay more than 13 percent to show the same real return.

Investing to beat inflation today means putting at least some money into stocks. Since 1926, the stock market has returned an average of more than 10 percent a year; it has been the only major investment category that has beaten inflation significantly. Although stocks can fluctuate in value significantly over short-term periods, historically they have proven to yield higher returns over the long run than either bonds or stable-value investments, which pay a contractual rate of interest.

Fear is a powerful motivator, however, and many investors choose bonds or stable-value investments over the ups and downs of stocks, seeking to avoid the volatility of the equity markets. Bonds and bond funds, though, flucuate in value with changes in interest rates, so they are not risk-free. In addition, their steadier performance comes at a cost—a lower expected rate of return. And the lower returns of stable-value funds offer even less opportunity for beating inflation.

Although it is a well-established truism that stocks and stock funds historically provide better returns than other kinds of investments, 75 percent of participants in defined-contribution plans own no stock or stock funds at all. Close to 60 percent of defined-contribution pension money is invested in stable-value instruments.

For many conservative investors, keeping a portion of retirement assets in conservative investments makes sense. But relying too heavily on bonds and stable-value investments exposes an investor to a loss of purchasing power. As retirement investors, people can afford to invest for the long term. And they do not stop being investors on the dates when they retire; they can expect to need funds for another 20 to 30 years. Long-term investors have the time necessary to ride out the volatility that comes along with equity investments, which are necessary ingredients in the best long-term investment plan.

How Much Is Enough?

The investment return we seek should be consistent with our financial goals in retirement and our personal investment profiles: our psychological makeup, other retirement income sources, time before we need the money, dependents during retirement. The ICMA Retirement Corporation's *Charting Your Course* retirement planning workbook can help with rough calculations.

As we estimate our financial needs in retirement, we should remember that over a long period of time, just a small increase in investment return can make a substantial difference in savings. A lump sum of $1,000 invested at 7 percent will be worth $3,870 in 20 years. This amount invested at 9 percent will grow to $5,604, giving 45 percent more money from a 2 percent better return.

With the higher expected rate of return, we must expect some periods when our investments will lag and may even decline in value for a while. But historically, volatility decreases over time, while rates of return are higher than for other investments. As a result, our savings have the potential for better growth, and isn't that why we were investing in the first place?

Maximizing tax deferrals and blending investments in a thoughtful growth portfolio will provide the best protection from inflation. (See the ICMA Retirement Corporation's *Investing for the Harvest Years* and *Portfolios for Your Future* for specifics on how to build a balanced portfolio.)

Remember, when we "save" our money, we are protecting it. When we "invest" our money, we are protecting ourselves. PM

Gordon Tiffany is a certified financial planner and director of financial and retirement planning at the ICMA Retirement Corporation. This article is the third in a four-part series on retirement planning. The concluding article will feature guidance on the basics of investing. For more information or to obtain copies of RC's retirement planning publications, call 1-800/669-7400.