THE Wealth REPORT

Inflation is indelibly tied to retirement planning because the federal government uses it as a benchmark to increase Social Security benefits and qualified retirement plan contribution limits. But is that enough?

HOW COULD INFLATION IMPACT YOUR RETIREMENT?

Overview

We've heard statistics about how the average life expectancy is longer than it used to be. More importantly, most of us know seniors who are living much longer in retirement than they probably expected. That's why now, more than ever, it's time to address a key issue that impacts retirement planning: inflation.

We've been lucky during the 21st century, as we've not experienced inflation rates as high as the latter 20th century. However, average annual inflation rates can be misleading; it's cumulative inflation that can devastate a retirement plan. Check out the difference in the table below.

Inflation Rates by Decade[1]

Decade	1960-1969	1970-1979	1980-1989	1990-1999	2000-2009	2010-2018
Annual Inflation	2.45%	7.25%	5.82%	3.08%	2.54%	1.80%
Cumulative Inflation	28.23%	103.45%	64.41%	33.47%	28.31%	14.16%

For an example of how cumulative inflation works, note that the cost of a product priced at $100 in 1990 would have more than doubled ($202.46) by the end of 2018 — and that was during a period of low inflation rates.[2]

Now let's look at inflation in retirement savings terms. If Bob saves $5,000 a year for the next 30 years, and his investment yields a 7% average annual return, he will accumulate a nest egg worth $505,365 when he retires. That sounds pretty good.

However, if during that time inflation grows at a 3% average annual rate, his $505,365 would buy the equivalent of only $208,204 today (not adjusted for taxes).[3] The takeaway is that while you may be saving toward a specific amount, it's important to be cognizant of how much that amount will buy you in the future.

With this knowledge in hand, retirees should consider how to best manage their retirement income prospects for the long term. Consider these inflation mitigation tactics.

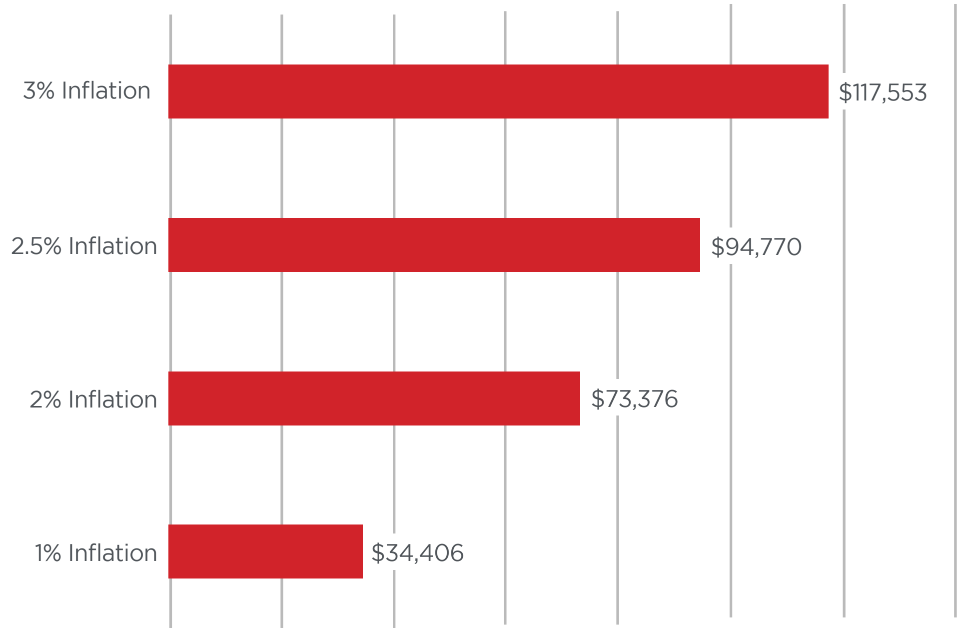
Social Security Optimization

Social Security benefits receive periodic cost of living adjustments (COLA) based on recent inflation data. However, there are two issues to consider. The first is that the COLA rate is linked to the Consumer Price Index (CPI), which is the weighted average of prices of a sample of consumer goods and services, such as food, housing and education.

The CPI is weighted based on the spending patterns of all urban consumers, wage earners and clerical workers. Unfortunately, retirees tend to spend more money on goods and services that experience higher levels of inflation, such as medical services. Therefore, the COLA for Social Security benefits may not keep up with a retiree's actual cost of living as he or she ages.

The following bar graph illustrates how various rates of inflation diminish the buying power of an average monthly Social Security benefit ($1,341/month) over a 20-year period.[4]

How Inflation Can Erode Social Security Income



One of the best ways to mitigate the impact of long-term inflation is to start out with the highest Social Security benefit for which you qualify. If you begin drawing benefits before your full retirement age (FRA), that payout will be permanently lower than if you wait until your FRA. Moreover, you can fully optimize your lifelong Social Security benefit by delaying until age 70, during which time it will increase by as much as 8% each 12-month period past your FRA.[5]

The following is a hypothetical example of how much the monthly Social Security benefit of a retiree (born in 1958 with current earnings of $100,000) would differ based on the age he begins drawing it:[6]

- Age 62: $1,706
- Age 65: $2,169
- Age 70: $3,174

An additional perk to delaying retirement is the ability to save and invest longer for a larger nest egg — which would then be needed for a shorter time frame.

Inflation-Aligned Investments

Another strategy is to allocate a portion of your retirement portfolio to investments that tend to grow in tandem with inflation. The following are some ideas you may wish to discuss with your financial advisor.

Series I Savings Bond

The U.S. government-guaranteed I-bond protects an investor from inflation by crediting his account with a fixed interest rate plus the annualized inflation rate of the preceding six months. The investor is protected from deflation because the account value does not drop when prices fall. An investor may purchase up to $10,000 in I-bonds each year. The earned interest is not subject to state and local taxes, and it is federal tax deferred until the bond is cashed. It has a 30-year duration but may be cashed after one year (subject to a minor penalty up to five years). Since it is not held in a retirement account, the I-bond is not subject to a withdrawal penalty before age 59 ½.[7]

TIPS

Treasury Inflation-Protected Securities (TIPS) are marketable securities whose principal changes in tandem with the CPI. The principal increases with a rise in inflation and decreases when inflation drops (adjusted every six months). The coupon rate remains fixed, so payouts vary based on the inflation-adjusted principal. Upon maturity, the investor receives the greater of the adjusted principal or the original principal, which protects him or her against deflation.[8]

CIPS

Corporate Inflation Protected Securities (CIPS) are similar to TIPS. However, they invest in corporate bonds and generally pay a higher yield composed of a fixed amount on top of the variable CPI rate.[9]

Dividend-Paying Stock Index Funds

Stocks that offer consistently rising dividends provide a robust hedge against inflation. By investing in an index fund that features a pool of dividend stocks, the investor benefits from both diversification to hedge market risk and inflated hedged income.[10]

REITS

A real estate investment trust (REIT) is a company that owns or finances a range of income-producing real estate, such as office buildings, apartment buildings, warehouses, retail centers or hotels. REITS pay out reliable dividend income that tends to rise with inflation, along with rental prices. According to the National Association of Real Estate Investment Trusts, REIT dividends have outpaced inflation in all but two of the past 20 years.[11]

IPA

An inflation-protected annuity (IPA) provides issuer-guaranteed income that increases each year based on a formula linked to the CPI. The initial income starts out low but compounds over time to generate higher payouts aligned with long-term inflation.[12] A secondary benefit to purchasing an annuity is that the owner can receive uninterrupted income for life without having to reinvest assets during later stages of retirement.

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"For retirees, the case for income annuities becomes even stronger in today's low interest rate environment. This is because annuities' payouts are not affected by interest rates."[13]

Final Thoughts

It's important to work with a financial advisor to develop a retirement portfolio that keeps working long after you stop. It needs growth, diversification, reliable income, inflation protection and a hedge to help ensure you won't run out of money.

To address all of those factors, an investor can't get too caught up in what's going on with day-to-day market movements. Your thinking needs to be long-term — because today's retirement is long-term.

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