Protecting Your Nest Egg: The Hidden Impact of Inflation

By Randy Myers

In 1981, a gallon of gas cost $1.35, about a third of what it will set you back today. The price of the house you bought that year may have been about the same as the price of the car you purchased last month. This is inflation at work. The question is, what are you doing about it?

On Wall Street, inflation is a threat whose importance ebbs and flows from month to month as the Department of Labor compiles and releases data on consumer prices. On Main Street, where investors must make sure their retirement savings will last a lifetime, inflation is a constant enemy. Over time, even seemingly modest upticks in the cost of goods and services can jeopardize their financial security.

The problem, of course, is that inflation eats away at the purchasing power of retirement nest eggs. Over the course of 30 years — a plausible retirement period for many Americans — a 3.5 percent annual rate of inflation will cause the value of a dollar to fall to about 36 cents. Put another way, someone who can get by comfortably on $50,000 a year right now will need about $140,000 a year in 2041 if inflation holds at that pace.

Lately, it has. The Consumer Price Index (CPI), the most common measure of inflation in this country, rose at a 3.6 percent annual rate in July. That's above its historical average and high enough to worry some economists, who fear it could dampen the Federal Reserve's willingness to try to stimulate the still sluggish economy. Others contend that with the economy floundering, inflation is unlikely to get much worse in the months ahead.

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Either way, it's scant comfort for long-term investors looking to build a retirement nest egg that keeps pace with, or better yet, outpaces inflation. While workers enjoy a natural hedge against rising prices — wages tend to go up with inflation — retirees must depend on income from their investments.

"One of the questions I routinely ask clients is, 'What have you done to double or triple your income in retirement?'" says Kevin McGarry, director of retirement income strategies for financial services firm Nationwide Financial. "That's the magnitude of the issue. People really need to plan effectively if they want their investment portfolio to outperform even a seemingly modest inflation number."

Eric Thomes, senior vice president with Allianz Life Insurance Company of North America, agrees. "Inflation is one of the top risks in retirement that people don't often think about," he says. "With no cost-of-living increases to Social Security over the past two years, many retirees are already feeling the effects of what fixed payments with no chance for increase would be like. It's important that people address this issue when they're working with financial professionals to develop their retirement plans."

In fact, official inflation numbers may understate the risk of inflation for some people, since healthcare needs usually grow in retirement and healthcare costs have been rising faster than inflation generally. At the very least, the rising cost of healthcare can offset spending declines in other areas after someone stops working.

"The Consumer Price Index consists of a variety of goods and services — housing, transportation, food, entertainment, medical care, education, apparel and other personal expenses," McGarry explains. "Medical care has an approximate 6.6 percent weighting in CPI. At the beginning of retirement, healthcare accounts for about 25 percent of your essential expenses, and near the end of retirement it can account for almost 50 percent of your essential expenses. As other basic living costs decline later in retirement, such as transportation, entertainment, apparel and other expenses, investors still need to plan for a 3 percent inflation rate for their essential expenses during their retirement years."

There are, fortunately, ways to hedge against the ravages of inflation. The simplest is to make sure your investment portfolio includes assets that have historically outperformed inflation, such as stocks. Real estate and commodities often have done better too. More recently, inflation-protected bonds have helped investors stay ahead of the increasing cost of living, as have annuities with riders that automatically boost payouts to policyholders each year.

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