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"A Nickel Ain't Worth a Dime Anymore."

Our title contains wise words from the articulate Yogi Berra. In typical Yogi fashion, his comment is almost as confusing as the topic he was speaking about - inflation. Over time, the "five and dimes" have been replaced with "dollar stores," the average price of coffee has quadrupled, and Babe Ruth's $80,000 two year contract with the Yankees looks like a bargain compared to Alex Rodriguez's $275,000,000 ten year contract. This is all mostly a result of inflation.

There are both positive and negative implications of rising prices. In this article we aim to address inflation's impact on retirement savings and how investors can minimize the risk.

Simply put, inflation exists when more money is made available to purchase the same amount of goods. As the economy grows, businesses and consumers demand more goods and services. As demand increases, producers often raise their prices, resulting in inflation. As demand and spending outpace the production of goods and services, too much money chases too few goods and the purchasing power of a dollar declines. The two dollars that once bought you and three of your friends a cup of coffee, is now only enough for one cup.

The quantity of money in the system along with how quickly it changes hands affects its purchasing power. If the quantity of currency available decreases or those who hold the money are reluctant to spend, prices decline (deflation). When currency quantities increase along with spending, prices rise (inflation).

Other than just hearing from our elders about what they used to pay for a movie ticket, we can look back at commonly used measures of inflation. In the U.S. the most widely reported measure of inflation is the Consumer Price Index (CPI). The CPI reflects retail prices of goods and services including housing, transportation, and healthcare. Over the past thirty years, the CPI on average has increased between 3-4% annually.

So how does inflation impact you? Inflation is typically not a major concern when you are working. Your wages generally rise as the costs of goods and services increase. However, when you are living off your savings, inflation becomes a major risk.

Inflation chips away at real savings and investment returns. Most investors aim to maintain their purchasing power and standard of living throughout retirement. Inflation threatens this goal because investment returns must outperform inflation in order to maintain purchasing power. For example, an investment that returns 2% in an environment of 3% inflation produces a negative return of -1% adjusted for inflation. If you have $1,000,000 invested in money market savings accounts earning 1% ($10,000), and your costs of living rise 3%, you will be losing 2% ($20,000) per year of purchasing power.

Coming off of the dismal equity returns of the past decade, it has been comforting for some investors to maintain large cash positions in their portfolio. They may not be making much, but at least it appears they aren't losing anything. We caution investors about the risk of losing their purchasing power by remaining heavily invested in cash in an inflationary environment. This is especially important for aging retirees. With expenses such as health care costs skyrocketing, retirees can see their costs of living rise while their savings stagnate. A properly diversified portfolio of various asset classes can help reduce some of the inflation risk over the life of their plan.

So how do you protect your portfolio? In today's markets with historically low interest rates it is difficult to find fixed income securities that will offset inflation. There are some types of fixed income securities that are linked to changes in inflation. These include bonds issued by the U.S. government called Treasury Inflation-Protected Securities (TIPS). TIPS help protect investors from inflation because both their principal and interest payments adjust as the CPI changes.

Common stocks have often been a good investment relative to inflation over the long term. In a normal inflationary environment, companies with sustainable competitive advantages can raise their prices when their costs increase. Higher prices can translate into higher earnings over the long run for investors. However, over shorter time periods, unexpected or sudden rises in inflation can heighten uncertainty about the economy leading to lower earnings forecasts and equity prices.

Commodity based investments can also help cushion a portfolio against inflation because their prices generally rise along with inflation. However, some commodity based investments can be influenced by factors other than commodity prices. For example, oil stocks can fluctuate based on company specific issues rather than solely the price of oil.

In 2008, with the amount of government stimulus being spent around the globe, inflation seemed to be the number one concern for investors. However, as we have noted in our blog, governments were printing money at the same time investors were moving cash to the sidelines. So far, much of the stimulus has remained out of the system and we have yet to see significant near term inflationary pressures. Factors such as unemployment and consumer related uncertainty have kept some of the cash from returning to the market. Nevertheless, circumstances including low interest rates, continued government spending and rising production costs appear to be ripe for inflation to return. When prices do rise, investors need to make sure they are well positioned to keep up with inflation to maintain their standard of living throughout retirement.

The aforementioned assets – Treasury Inflation Protected Securities, common stocks, and commodity exposure is how we plan to mitigate this impact for clients.

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