Independent Investor

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Inflation Happens: Don't Let It Derail Your Long-Term Plans

A penny saved is a penny earned, right? Not necessarily. Thanks to inflation, over time that penny could be worth less than when it was first dropped into the piggy bank. That's why if you're investing—especially for major goals years away, such as retirement—you can't afford to ignore the corrosive effect rising prices can have on the value of your assets.

Inflation Under the Microscope

Just what is inflation, this ravenous beast that eats away at the value of every dollar you earn? It is essentially the increase in the price of goods or services. The most commonly referenced measure of that increase is the Consumer Price Index (CPI), which is based on a monthly survey by the U.S. Bureau of Labor Statistics. The CPI compares current and past prices of a sample "market basket" of goods from a variety of categories including housing, food, transportation and apparel. The CPI does have shortcomings, according to economists: It does not take taxes into account or consider that as the price of one product rises, consumers may react by purchasing a cheaper substitute (name brand vs. generic, for example). Nonetheless, it is widely considered a useful way to measure prices over time.

Inflation has been a very consistent fact of life in the U.S. economy. Dating back to 1945, the purchasing power of the dollar has declined in value every year but two—1949 and 1954. Still, inflation rates were generally considered moderate until the 1970s. The average annual rate from 1900 to 1970 was approximately 2.5%. From 1970 to 1990, however, the average rate increased to around 6.0%, hitting a high of 13.3% in 1979.[1] Recently, rates have been closer to the 1% to 3% range; the inflation rate has been 2.06% thus far in 2014.

What It Means to Your Wallet

In today's economy, it is easy to overlook inflation when preparing for your financial future. An inflation rate of 4%, for instance, might not seem to be worth a second thought—until you consider the impact it can have on the purchasing power of your money over the long term. For example, in just 20 years, 4% inflation annually would drive the value of a dollar down to $0.44.

Or look at it another way: If the price of a $1,000 refrigerator rises by 4% over 20 years, it will more than double to almost $2,200. A larger-ticket item, such as a $23,000 automobile, would soar to more than $50,000 given the same inflation rate and time period.

Inflation also works against your investments. When you calculate the return on an investment, you need to consider not just the interest rate you receive but also the real rate of return, which is determined by factoring in the effects of inflation. Your financial advisor can help you calculate your real rate of return.

Clearly, if you plan to achieve long-term financial goals—from college savings for your children to your own retirement—you will need to create a portfolio of investments that will provide sufficient "inflation-adjusted" returns.

Investing to Beat Inflation

Insulating your portfolio against the threat of inflation might begin with a review of the investments most likely to provide returns that outpace inflation.

Over the long run—10, 20, 30 years, or more—stocks may provide the best potential for returns that exceed inflation.[2] While past performance is no guarantee of future results, stocks have historically provided higher returns than other asset classes.

Consider these findings from a study of Standard & Poor's data: An analysis of holding periods between 1926 and December 31, 2013, found that the annualized return for a portfolio composed exclusively of stocks in the Standard & Poor's Composite Index of 500 Stocks was 10.14%—well above the average inflation rate of 2.96% for the same period. The annualized return for long-term government bonds, on the other hand, was only 5.52%.[3] In addition, the study found that the stock portfolio did not suffer a loss in 817 separate 20-year holding periods. In every period, the annual rate of return for the stock portfolio was greater than the inflation rate. The bond portfolio outpaced inflation in only 447 of the 817 20-year holding periods—by a much lower margin.[4]

A Balancing Act

Keep in mind that stocks do involve greater risk of short-term fluctuations than other asset classes. Unlike a bond, which offers a fixed return if you hold it until maturity, a stock can rise or fall in value based on daily events in the stock market, trends in the economy or problems at the issuing company. But if you have a long investment time frame and are willing to hold your ground during short-term ups and downs, you may find that stocks offer greater potential to beat inflation.

The key is to consider your time frame, your anticipated income needs and how much volatility you are willing to accept, and then construct a portfolio with the mix of stocks and other investments with which you are comfortable. For instance, if you have just embarked on your career and have 30 or 40 years until you plan to retire, a mix of 70% stocks and 30% bonds might be suitable.[5] But even if you are approaching retirement, you may still need to maintain some growth-oriented investments as a hedge against inflation. After all, your retirement assets may need to last for 30 years or more, and inflation will continue to work against you throughout.

Take Steps to Tame Inflation

Whatever your investor profile—from first-time investor to experienced retiree—you need to keep inflation in your sights. Stocks may be your best weapon, and there are many ways to include them. Consult your financial planner to discuss your specific needs and options.

[1]Source: U.S. Bureau of Labor Statistics.

[2]Source: Investing in stocks involves risks, including loss of principal.

[3]Source: Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

[4]Source: Standard & Poor's. Stocks are represented by the S&P 500, an unmanaged index that is generally considered representative of the U.S. stock market. It is not possible to invest directly in an index. Bonds are represented by a composite of returns derived from yields on long-term government bonds, published by the Federal Reserve, and the Barclays Long-Term Government Bond index. Inflation is represented by the change in the Consumer Price Index. Past performance is not a guarantee of future results.

[5]These allocations are presented only as examples and are not intended as investment advice. Please consult a financial advisor if you have questions about these examples and how they relate to your own financial situation. The investor profile is hypothetical.