



## Points of Interest – Inflation Risk

### Best Route



A good benchmark for developing your inflation rate assumption is the Consumer Price Index measured over a longer period of time. Add in a margin of 1% or more to that figure. **Using this approach, you'll end up with a range of 3.5%-5% for your long-term inflation rate.** Keep in mind though, inflation and its effects are unpredictable. Work with your advisor to keep track of the actual rate so you can make any adjustments along the way.

*With a sound strategy, your advisor can help you prepare for retirement income for the long run.*

## How inflation affects your retirement income over time

Apart from the more recent attention to inflation in the media, you may not have given inflation much thought. The double digit inflation rates of the '70s and '80s are only a distant memory. But because **inflation lowers the purchasing power of money**, even a modest level of inflation can take a significant toll on your retirement purchasing power and lifestyle over time. That's why it's important to take inflation into account when developing your retirement income strategy.

### Measuring the true cost of inflation







Everyone understands as prices go up, purchasing power decreases, because each dollar buys a smaller portion of goods and services. But when you look at inflation in concrete terms – the cost of things you pay for every day – it's impact is more understandable.

Consider this: At 3% inflation, the weekly groceries you purchased for \$100 today might run \$103 next year. While you might not think that's a big deal, factor that 3% over a longer period of time and it takes a serious toll on your standard of living. If prices continue to grow by 3% each year, in 25 years you'll need \$209 to pay for those same groceries, an increase of 109%. So if your income isn't keeping up with the pace of inflation, you'll lose financial ground over the long term.

As the [chart on the following page](#) shows, inflation reaches into your retirement wallet and steals away more and more of your hard-earned dollars.

Explore more 

## The real cost of inflation (as of July 2010)

	1980	1990	2000	2010	% Increase (since 1980)
 1st class stamp	.15	.25	.33	.44	193%
 1 gallon regular unleaded gas	1.27	1.08	1.59	2.74	107%
 1 gallon whole milk	1.45	2.21	2.78	3.31	128%
 1 movie ticket	2.69	4.23	5.39	7.95	196%
 Bread per pound	.51	.69	.94	1.36	167%
 Coffee 100% ground roast per lb.	3.23	3.05	3.45	3.86	20%

Sources: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Indexes; Motion Picture Association of America; Postal Regulatory Commission

## Inflation can also affect the value of your investments

Not only does inflation increase the cost of goods and services, it can also eat into your investment returns – that’s especially true of fixed investments.

▶ **For example**, let’s assume you purchase a \$10,000 Treasury bill with a 5% annual interest rate and hold it for one year. At the end of that year, you receive \$10,500. But if inflation increased by 3% that year, your earnings would really be 5% minus 3% (or 2%), or \$10,200. So in order to gain real value, investments must earn a rate of return that’s higher than the rate of inflation.

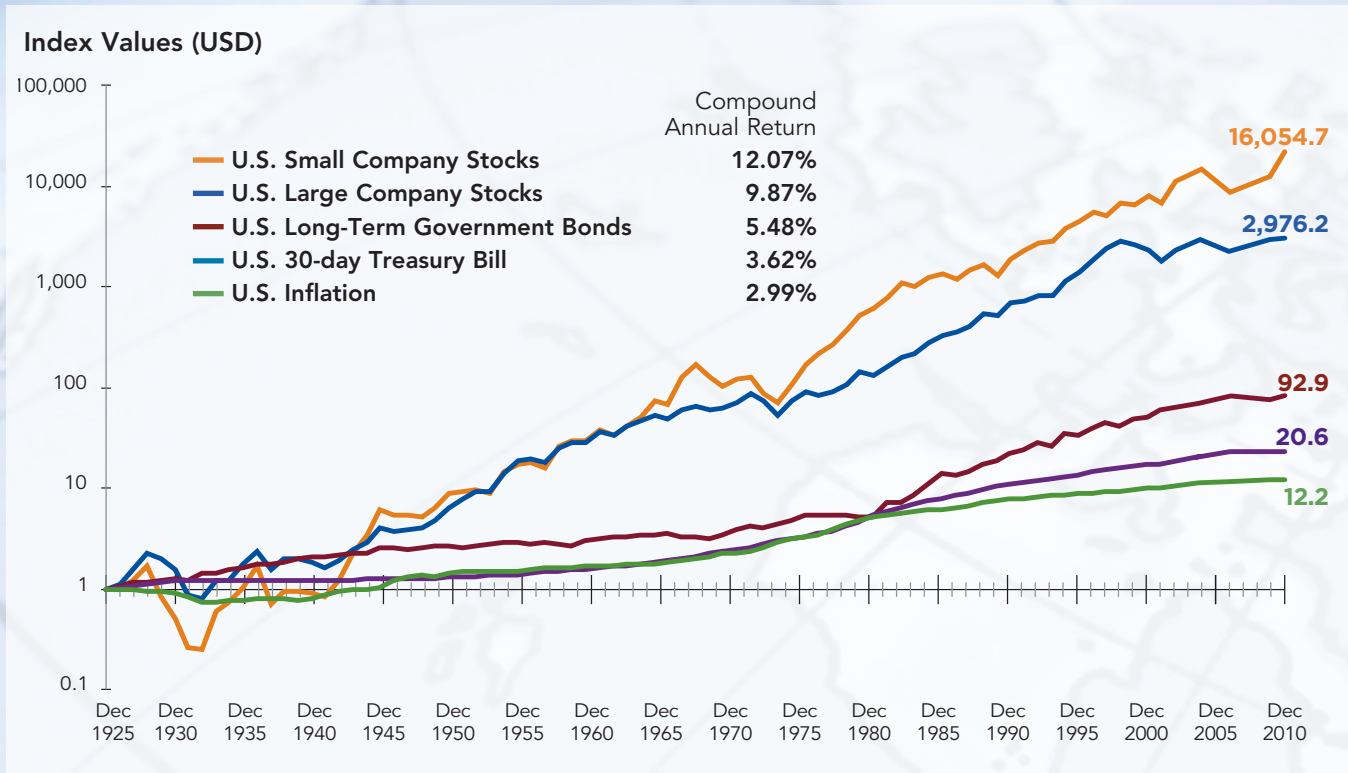
Although past performance doesn’t guarantee future results, historically both equity and bond investments have outperformed inflation. The [graph above right](#) illustrates how the long-term appreciation of stocks, bonds and cash relates to inflation, as measured by the CPI.

The chart illustrates the hypothetical value of \$1 invested at year-end 1926 and assumes reinvestment income and no transaction costs or taxes. Of course, it is for illustrative purposes only and isn’t indicative of any particular investment.

## Stocks, bonds, bills and inflation\* index sources:

- **U.S. Small Company Stocks:** Represented by the fifth capitalization quintile of stocks on the NYSE for 1926-1981 and the performance of the Dimensional Funds Advisors (DFA) Small Company Fund thereafter.
- **U.S. Large Company Stocks:** S&P 500 Index; an unmanaged group of securities and is considered to be representative of the stock market in general.
- **U.S. Long-Term Government Bonds:** 20-year U.S. Government Bond.
- **U.S. 30-day Treasury:** 30-day U.S. Treasury Bill.
- **U.S. Inflation:** Consumer Price Index.

## Stocks, bonds, bills and inflation® 1926-2010



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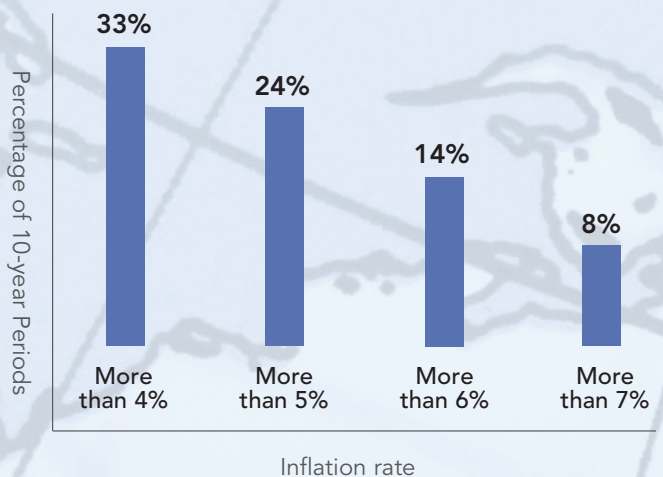
### Consider average inflation rates since 1927

As shown in the [chart to the right](#), for 24% of the time the inflation rate exceeded 5% over a 10-year period, and for almost 10% of the time it exceeded 8% for the same time period. Although future results are unpredictable, it helps to be aware of the historical range.

### Factor inflation into your investment strategy

Consider your investment mix. Although past performance is no guarantee of future results, equity investments have historically outperformed inflation over the long term as shown in the chart above. Make sure that your retirement portfolio includes a mix of investments that meet your asset allocation needs, while also guarding against inflation.

### Percentage of 10-year periods since 1927 where inflation averaged more than 4%



Source: 2010 U.S. Bureau of Labor Statistics ([www.bls.gov](http://www.bls.gov)) through 2009

## How can you minimize the effects of inflation on your retirement income?

Although you certainly can't control the rate of inflation, there are some steps you can take to minimize the financial impact of inflation; regardless of how close (or far away) you may be from full-time retirement:

### Plan for both best and worst case scenarios:

Include both conservative and aggressive inflation rates in your future assumptions and estimates. Make sure you also adjust your assumptions regarding required retirement income to compensate for actual inflation rates.

### If you're accumulating savings:

- Maximize your savings and investments to meet worst-case inflation scenarios.
- Include the impact of future taxes to determine how to allocate your investments between taxable, tax-deferred, and tax-advantaged programs.
- Don't wait – procrastination is one of the primary reasons that inflation begins to take its toll. Even small positive steps can minimize the effects of inflation over time.

### If you're receiving retirement income:

- Include an inflation assumption in your income needs.
- Determine the percentage of your budget spent on items that increase at a rate greater than inflation. Compare your results with the average inflation rate to see how your spending habits vary.
- Consider incorporating equity investments in your retirement income portfolio to increase the likelihood of staying ahead of inflation.
- Develop a sound tax strategy around the goal of keeping a greater share of what you earn.

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F69939 Rev 1-2011 DOFU 1-2011  
(A00855-0209)  
A05154-1210