Key Wealth Insitute

Why Is Inflation So Scary for My Retirement Plan?

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Why is the impact of inflation on a retirement plan a hot topic?

Over the past decade, investors experienced a best-case scenario of relatively low inflation and strong investment returns from stocks and bonds. A retirement portfolio could maintain or even grow in value, enabling a retiree to comfortably sustain a withdrawal rate that met their spending needs. For many, worrying about inflation seemed to be a thing of the past.

That perspective has changed as rising inflation has become headline news and the potential for further pressure on price levels is coming from a number of sources. These include: (1) massive monetary stimulus; (2) reopening of the economy following the COVID-19 pandemic; (3) a surge in consumer spending as a result of rising net worth; and
(4) inventory rebuilding by businesses.

As the prospects for higher inflation mount, there is also a heightened probability that we may be in for a protracted period of low interest rates. This may cause many retirees and those planning for retirement to worry that their investment portfolios may fall short of expectations.

What does history tell us?

An environment of high inflation and low returns may be uncommon, but its impact on investors can be severe, as our experience in the 1970s illustrates. In 1973, the inflation rate increased to 6%, and the S&P 500 dropped 15%. The inflation rate was 11% in 1974, and stocks lost 26% of their value. Interest rates were high from a historical perspective, resulting in fixed-rate investments generating more interest income for retirees. However, inflation consumed the increase in income. This experience from 50 years ago may be contributing to concerns that investments might not keep pace with inflation[1] in the future.[2]

Period	Avg. Annualized CPI	Avg. 10-Year Treasury Yield (%)	Avg. Annualized S&P Return (%)
1950 – 1959	2.07%	4.84	12.66
1960 – 1969	2.35%	5.16	5.19
1970- – 1979	7.09%	7.50	1.77
1980 – 1989	5.54%	10.23	11.18
1990 – 1999	3.00%	6.39	17.98
2000 – 2009	2.57%	4.16	-1.85
2010 – 2019	1.77%	2.38	11.08
1950 – 2020	**3.48%**	**5.91**	**7.71**

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Swings in inflation rates such as those we have witnessed over the past several decades can have a significant impact on retirement security. Rising price levels cause you to spend more to maintain your standard of living, which often means having to take larger withdrawals from your portfolio.

Differences in the inflation rate of a few percentage points can add up over time, as the table below shows:

Annual basic living expense	25 years later @ 2%	25 years later @ 4%	25 years later @ 6%
$60,000	$98,436	$159,950	$257,512
$100,000	$164,061	$266,583	$429,187
$120,000	$196,873	$319,900	$515,024
$240,000	$393,745	$639,801	$1,030,049

How can you prepare for a secure retirement in coming years?

We believe that the environment in the coming decades will most likely resemble the period from the 1980s through the early 2000s. During these years, investors had either inflation or investment returns in their favor but not both at the same time.

During the planning process, quality financial teams will help you build confidence by incorporating various inflation scenarios and assumptions as well as prioritizing lifestyle needs, wants, and wishes. For example, healthcare costs are assumed to increase at a higher inflation rate than most other spending. However, additional discretionary travel for many clients is often considered a wish that can be a flat expense or only at the average inflation rate.

In addition to examining each of these expense categories in your comprehensive financial plan, it's important to review your withdrawal assumptions. Working together with your advisor, you can then decide if you need to be more conservative in spending.[3]

As part of our portfolio management process, we provide you with insights on asset allocation and investment strategies to help you hedge against or even outearn inflation over time. For example, investing in Treasury Inflation-Protected Securities and increasing the allocation to equities are strategies that are often used to increase returns during periods of high inflation. Investing in real estate, infrastructure, and other types of alternative assets may also apply.[4]

It is also critical that your advisor helps you understand the difference between inflation and reflation and how each affects investments.

And even in an environment of rising inflation, there are still reasons to consider fixed income as part of a diversified portfolio.

You may also find opportunities as part of the regular review of your comprehensive financial plan. For example, the planning process can help you explore the impact of other financial decisions, such as when to claim your Social Security benefit.

You may collect benefits at age 62[5], but waiting to claim as late as age 70 results in a larger benefit that is inflation adjusted. According to the Social Security Administration, if you began claiming in 2023 at your full retirement age, your maximum benefit would be $3,627. However, in 2023, if you began claiming early at age 62, your maximum benefit would be $2,572. And in 2023, if you began claiming at age 70, your maximum benefit would be $4,555.

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About the Author

Renee Porter-Medley is a highly experienced professional who works closely with the relationship team to understand a client's situation and goals and develop an integrated, customized set of strategies to help them reach their objectives. She is also well-versed in sophisticated planning strategies to help clients address complex issues. Renee is a Key Private Bank Wealth Institute member, which provides commentary and advice on current topics and issues that impact our clients' wealth management planning.

Renee is a Certified Financial Planner® professional who completed her coursework through the College for Financial Planning and attended the Financial Planning Association Residency Program at DePaul University. She taught other professionals as an Instructor for the Certified Financial Planner Certification™ program offered by Florida Gulf Coast University. Renee earned a Bachelor of Arts in International Studies with a major in Finance from the University of Michigan and a Master of Professional Studies in Organization Development from Penn State University.

[1-4] https://www.morningstar.com/personal-finance/when-higher-inflation-meets-your-withdrawal-rate

[5] https://faq.ssa.gov/en-us/Topic/article/KA-01897

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