PROTECT YOURSELF FROM THE DANGERS OF INFLATION

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How Investing for Income Helps Protect You From the Dangers of Inflation

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After more than a decade of hovering at normal-to-below-average levels, inflation became a hot topic again in 2021 when it rose to over 4%. By March 2022, it had hit a 40-year high of 8.5%. This prompted the Federal Reserve to take its usual course of action to combat inflation: raising short-term interest rates. Over the next 18 months, the Fed hiked rates at a historically aggressive pace. As usual, this created extreme volatility in the financial markets, but ultimately inflation did come down again to just over 3% by late 2023.

Nobody likes rising prices, but one positive outcome of the recent inflation spike is that it has prompted more people to think about inflation as it relates to their retirement goals. According to a recent survey by Global Atlantic Financial Group, 71% of Americans aged 59 to 75 said they believe rising inflation will negatively affect their retirement savings, while 46% said they believe inflation will make it more difficult to have a steady income in retirement. [1]

Those are valid concerns, but the good news is that at least people are thinking and talking again about the potential long-term effects of inflation. It's good because underestimating the impacts of inflation is one of the most common and devastating mistakes people make when it comes to retirement planning. But it doesn't have to be that way.

As the saying goes, forewarned is forearmed, and it is possible to "arm yourself" very well against the long-term effects of inflation. We'll explain how in this report. You will learn:

•The many ways in which inflation can negatively impact your retirement.
•The even more dangerous effects of healthcare inflation.
•Steps you can take ahead of retirement to combat the future effects of inflation.
•How a financial strategy geared toward retirement income can ultimately help make your retirement plan "inflation-proof."

Let's start with some basics.

Inflation 101

The textbook definition of inflation is too much demand chasing too few goods and services. This is exactly what we saw in 2021 when the latest inflation spike began. As everyone knows, the coronavirus pandemic interrupted global supply chains. As a result, when businesses began fully opening again after the pandemic, many products were scarce. Also, businesses in the service industry were now understaffed, so they too had to raise prices. Couple this with the huge number of consumers eager to shop, travel, and eat out again after the long lockdown, and high inflation was probably inevitable.

Of course, for a variety of reasons, the average cost of goods and services is always rising to some degree. The Bureau of Labor Statistics, which measures inflation through the Consumer Price Index, considers the "normal" inflation rate to be anywhere between 2 and 3 percent. [2] When inflation climbs above that rate for an extended period, the Federal Reserve sometimes steps in to try to tame inflation, typically by raising short-term interest rates, as noted. It's a risky strategy because its goal is to address the problem of "too much demand" by getting people to spend and borrow less. This can be an effective way to lower inflation, but it sometimes comes at the cost of tipping the economy into a recession.

Investors are well aware of this risk, which is why the financial markets always become volatile when the Fed is raising rates. Fear grips the stock market and sell-offs occur in the bond market that push long-term interest rates upward, thus pushing down the values of virtually all invested assets. As a result of the Fed's inflation-fighting efforts in 2022, the stock market had its worst performance in 14 years, with the S&P 500 dropping by over 19 percent. [3]
The point here is that the danger of inflation isn't just that it diminishes the purchasing power of

Source: Bloomberg, Dec. 30, 2022

your income; it can also trigger market conditions that erode your savings. When planning for retirement, you need a financial strategy that effectively arms you against both dangers.

Erosion Over Time

Because "normal" inflation is so ingrained in our economy, most people take it for granted and don't realize how truly corrosive it can be over time. That's less of a danger when you're working than it is when you're retired and need to be more budget-conscious. Consider how inflation at even a normal rate of 2-3% could affect your finances over the next 20 years:

- If you needed $60,000 for your first year of retirement, in 20 years you would require over $108,000 to match today's purchasing power of $60,000.
- Another way to look at it is this: At a 3% annual inflation rate, that initial $60,000 would be worth only a little over $33,000 in 20 years.

That's scary enough, but what makes it even scarier is the fact that people are living longer than ever these days. With today's average longevity rates, you generally need to plan for up to 30 years of retirement income, not 20.

Unfortunately, there's more bad news because, while inflation affects all age groups, its harshest effects are felt by older Americans for several reasons. One is that if you're retired, you're more dependent on your invested assets to provide income. Therefore, the market volatility typically caused by inflation (which we just discussed) can have a more direct and damaging impact on your quality of life.

Also, whenever prices rise, they tend to do so more dramatically on many products and services typically needed by older Americans – so much so that the Bureau of Labor Statistics uses an entirely separate gauge to track inflation for Americans 62 and over called the Consumer Price Index for the Elderly, or CPI-E.

Healthcare Inflation

Naturally, many of the products and services needed most by older Americans are healthcare-related: prescription drugs, doctor visits, physical therapy, hospital stays – the list goes on. What's scary about that is that over time healthcare costs invariably rise at a much faster and steeper rate than consumer costs in general. Be aware:

- Since 2000, the price of medical care, including services provided as well as insurance, drugs, and medical equipment, has increased by 114.3 percent. In contrast, prices for all consumer goods and services rose by 80.8% in the same period. [4]
- And since 1948, the price of medical care has grown at an average annual rate of 5.3% compared to 3.5% for general inflation. That's close to 6%, which means healthcare and medical costs essentially double every 12 years. That includes everything from prescription drugs to long-term care. [5]

As for drugs, according to the Employee Benefit Research Institute:

- A 65-year-old man with average insurance premiums in retirement would need about $96,000 saved just to have a 50% chance of covering his premiums and median prescription drug costs.
- A woman in that same situation would need to have saved $116,000.
- To have a 90% chance of meeting their healthcare spending needs in retirement, a man would need to have saved $166,000, and a woman would need to have saved $197,000. [6]

And what about long-term care? Well, with costs doubling every 12 years, consider this:

- If you're in your 60s today and budgeting as much as $200,000 a year for full-time in-home care, by the time you need it in your late 80s or early 90s, the expense could be four times as high, or $800,000.

It's also important to be aware that insurance coverage – including Medicare – for long-term care is extremely limited, which is why some people choose to purchase long-term care insurance specifically. Depending on your situation it can be a smart move, especially when you consider that according to a study by the Department of Health and Human Services, someone turning 65 today has almost a 70% chance of needing some type of long-term care services and supports in their remaining years. [7]

What About Social Security?

As most people know, the Social Security Administration approves a Cost-of-Living Adjustment, or COLA, for Social Security beneficiaries every year. That's nice, but the fact is, even with the unusually high COLAs of the past few years, over the long run Social Security has not kept up with the average pace of inflation:

- According to a recent study by the Senior Citizens League, inflation has caused Social Security payments to lose nearly 40% of their buying power since 2000. [8]
- In some years, the COLA adjustment has been nonexistent or nearly so. For example, it was 0.3% for 2016 and 0% for 2015.

SSA COLA
INCREASES SINCE 2012

2012 – 1.7%
2013 – 1.5%
2014 – 1.7%
2015 – 0%
2016 – 0.3%
2017 – 2.0%
2018 – 2.8%
2019 – 1.6%
2020 – 1.3%
2021 – 5.9%
2022 – 8.7%
2023 – 3.2%

Source: SSA.org

But it gets worse. Although the COLA was set at 5.9% in 2021, 8.7% in 2022, and a still-higher-than-normal 3.2% in 2023, understand that even a significant benefit increase is often undercut by increased premiums for Medicare Part B. In 2022, for instance, Medicare Part B premiums rose by 14.5%, one of the biggest jumps in the program's history. [9]

Again, these are just some of the reasons why even moderate inflation hits retirees and near-retirees harder than younger people. They're also some of the reasons why it's important to arm yourself against long-term inflation and to try to make your retirement plan "inflation-proof" as much as possible. So, now let's look at some steps you can take ahead of retirement to help you do just that.

Preventive Measures

While there's no way to escape inflation, you can take steps to minimize its impact on your retirement, and the sooner you start, the better. Here are seven preventive measures you can take starting today:

1. If you're not already making the most of your employer-sponsored match to your 401(k) contributions, do so. Even though the size of your nest egg is only one ingredient in a successful retirement plan, the more money you have working for you, the better.
2. Pay down your debts as much as possible before retirement. If you can, pay them off. While carrying some debt into retirement is okay (and can even be beneficial) heavy debt can increase the severity of every financial challenge you'll face, including inflation. Start with your high-interest credit cards, and consider seeing a specialist about consolidating your debts, if possible, to lower the interest burden.
3. Identify or modify – if necessary – your retirement goals. Inflation could prompt you to want to change the timetable on some of your goals or make financial moves now that can better help you achieve them.
4. Keep an eye on the Fed. How the Federal Reserve does or doesn't respond to inflation is one of the biggest factors in determining: A) how long it may last, B) how bad it may get, and C) how it might affect the financial markets and, thus, your investments, as we've discussed.
5. Start planning now to maximize your Social Security benefits. Even though Social Security doesn't keep up with inflation over the long run, and although your benefits account for only part of your retirement income, maximizing them is still essential. The more income you can work with during an inflationary environment, the better off you'll be.
6. Make sure you have a financial strategy that is flexible enough to both anticipate and respond to the potential impacts of inflation.
7. Finally, make sure to continuously review and adjust your flexible strategy if necessary. Inflation is never static, and economic conditions are constantly changing. Therefore, it's important to regularly review your portfolio with your advisor and adjust your strategy based on current conditions and market trends. This proactive approach allows you to make informed decisions, ensuring that your investments remain both effective and aligned with your goals. This is important ahead of retirement and becomes even more important once you're retired.

Inflation and the Income Model

Now, let's talk about how investing for income not only helps to ensure you'll take the precautionary steps outlined above, but continues to keep you well-armed against inflation throughout retirement.

For starters, investing for income offers a much more strategic approach to retirement planning compared to investing for growth – and the key to beating inflation is having a real strategy. A growth-based approach leaves too much to chance, while the income model leaves very little to chance. Investing for growth typically involves using a "withdrawal strategy" that involves taking a certain amount (usually 4% or less) from your principal every year to satisfy your income needs.

The danger there is that you're then dependent on market growth to replenish that withdrawal, and you can't always count on that. Sometimes instead of growth, you get shrinkage, and – as we've seen – that's especially true in an inflationary environment when the Fed is raising interest rates.

By contrast, when you invest for income, you're typically investing primarily in contract-based tools and strategies designed to protect your principal and generate reliable income at a fixed rate of interest or dividend. For example, in a conservative income portfolio of actively managed individual bonds and bond-like instruments, even though your bond values may drop on paper when the market sinks as long-term interest rates rise, you have a contract guaranteeing the return of the face value of your investment if you hold the bond to maturity, and provided there is no default. That same contract also ensures that your interest/income return is unaffected during a down market. Some of these same kinds of safeguards can also apply (though to a lesser degree) when you shift your equity strategy from one focused on capital gains to one focused on stock dividends.

More Future Income Potential

What's more, with an actively managed income strategy you have the potential to increase your future income through strategic reinvestment. That's because when the market drops, you're able to purchase more shares for the same price – you're able to buy low, in other words, which is a cornerstone of good investing. Essentially you are dollar-cost-averaging your way to more potential income in the future when the market recovers – and the more income you can work with, obviously the better equipped you'll be to deal with all the challenges posed by long-term inflation. In other words, an advisor who specializes in income can help you engineer an inflation hedge through strategic reinvestment. In addition, many income-based investment vehicles – such as certain annuities, dividend-paying stocks, and I-bonds – include options intended to provide inflation protection.

In short, an advisor who specializes in retirement income uses a variety of techniques and strategies to help you keep pace with inflation and even stay ahead of it, starting with many of those preventive measures we mentioned, including helping to ensure you maximize your Social Security benefits; that you avoid paying unnecessary taxes; that you stay informed about the Federal Reserve; and that you regularly review and modify (if necessary) your strategy based on changing market conditions or changes to your goals or situation.

In addition to all that, the income model also accounts for today's longer lifespans and therefore gives you a strategy that helps make your retirement plan "inflation-proof" not just for 10 or 20 years, but for 30 years or as long as you need it!

Learn More

To learn more about how investing for income can help protect your retirement from the many negative impacts of inflation, contact our office today. When you do, you'll receive our free Retirement Risk Report and the opportunity to schedule a free, no-obligation consultation.

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