Inflation: The Beast in the Closet

Inflation has been edging up lately. Although still moderate, the uptick is a reminder that inflation can, and periodically does, spike -- a fact that any long-term financial plan should take into account.

For most Americans, high inflation is just a distant memory. The last time that the Consumer Price Index (CPI) registered an annual increase above 4% was in 1991 -- over 25 years ago.[1] And in the five years ended December 31, 2017, it averaged a tepid 1.4%.

In May, the CPI increased by 2.8% from a year earlier, its highest rise in over six years.

But lately, inflation has been creeping up. In May, the CPI increased by 2.8% from a year earlier, its highest rise in over six years. A big part of May's increase reflects a rise in energy prices, but mounting inflationary pressures are evident elsewhere. A thriving economy, a tight labor market, a housing boom, the stimulative effects of the $1.5 trillion tax cut passed in December, and most recently, an escalating trade war -- all are putting upward pressure on prices.

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 1926 to 1970 was approximately 1.9%. From 1970 to 1990, however, the average rate increased to around 6%, hitting a high of 13.3% in 1979.[2]

But even at moderate levels, inflation can still take a toll on investments over time. Consider that the purchasing price of $1,000 would erode to just $737 if subject to 3% inflation over 10 years. So, for investors, especially retirees and others depending on fixed-income investments, inflation is a real concern.

DST PROOF Retirement Solutions

Inflation Run Amok
There's inflation, and then there's hyperinflation. History offers any number of jaw-dropping examples of just how bad inflation can get. By some measures, Venezuela's annualized inflation rate topped 25,000% in May. But this is tame compared with Peru in 1990, when prices increased 5% a day, or Weimar Germany in the early 1920s, where people had to cart wheelbarrows of cash to buy groceries. Worse yet was Hungary following World War II, when prices doubled every 15 hours.

Investing to Stay Ahead of Inflation

Guarding your portfolio against the corrosive effects of inflation might begin with a review of the investments most likely to provide returns that outpace it.

Over the long run -- 10, 20, or 30 years or more -- stocks may provide the best potential for returns that exceed inflation. 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 returns between 1926 and December 31, 2017, found that the annualized return for a portfolio composed exclusively of stocks in the S&P 500 index was 10.22% -- well above the average inflation rate of 2.89% for the same period. The annualized return for long-term government bonds, on the other hand, was only 5.63%.[3]

There are many ways to include stocks in your long-term plan. There are thousands of stock mutual funds or stock exchange-traded funds to choose from, both of which offer the benefits of liquidity and diversification.[4] Or, you could create a portfolio of shares from companies you select.

Keep in mind that stocks do involve greater risk of short-term fluctuations than other asset classes. Unlike a bond, which promises 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 the best chance to beat inflation.

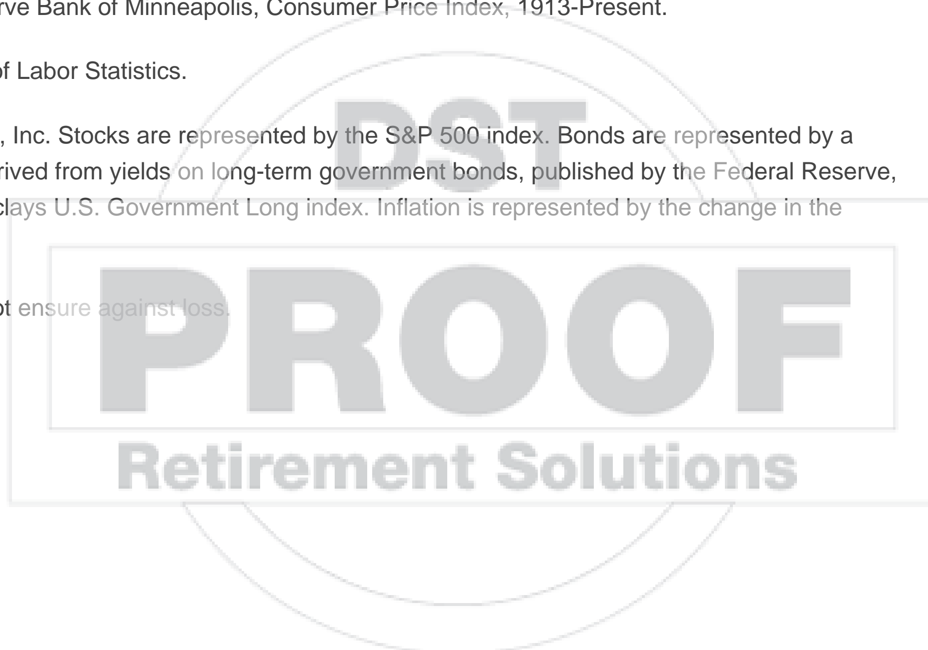
The key is to consider your time frame, your anticipated income needs, and how much volatility you are willing to accept, and then construct a portfolio with the mix of stocks and other investments with which you are comfortable. But even if you are approaching or in retirement, you may still need to 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 likely continue to work against you throughout.

[1] Source: Federal Reserve Bank of Minneapolis, Consumer Price Index, 1913-Present.

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

[3] Source: DST Systems, Inc. Stocks are represented by the S&P 500 index. Bonds are represented by a composite of returns derived from yields on long-term government bonds, published by the Federal Reserve, and the Bloomberg Barclays U.S. Government Long index. Inflation is represented by the change in the Consumer Price Index.

[4] Diversification does not ensure against loss.



© 2018 DST Systems, Inc. All rights reserved. Reproduction in whole or in part prohibited, except by permission. All rights reserved.