

By William J. Lynott

How Inflation Will Affect Your Retirement

Inflation is inevitable, so learn how to factor it into your retirement planning.

EXCEPT FOR THE RECENT SPIKE IN GASOLINE PRICES, chances are you haven't given much thought to inflation lately. Those white-hot cost of living increases in the '70s, '80s and early '90s (5% to 13%) are largely a memory now, and with overall inflation hovering between 2.5% and 3% you probably believe there are more important economic challenges to consider, both professionally and personally. But the truth is that inflation, the lowering of the purchasing power of money, is destined to exert a major influence on your future economic well-being. As a small-business owner managing your own retirement, you need to consider the effects of inflation now, whether your golden

years are a long way off or just around the corner.

To understand why inflation should be a consideration in your retirement planning, it's important to keep in mind that inflation and its effects are unpredictable. If you've been around long enough to remember 1955 and McDonald's 15-cent hamburger, you may get nostalgic shelling out 89 cents for that same item today. But which is the better deal? Surprise! That hamburger would be selling for about \$1.03 now had it kept pace with inflation, so it's actually cheaper today than it was 50 years ago!

Unfortunately, McDonald's hamburgers are a rare exception. Most of the products and services we buy keep pace with—or exceed—the average inflation rate. For example, during the Great Depression, a first-run movie ticket sold for 15 cents. How does that compare to today's ticket prices? With inflation factored in, a movie ticket should cost only \$2.03 today. So, with ticket prices now running at \$6.50 or higher, it's costing us a lot more to visit the local movie theater than it did back in the dark days of the Depression (and don't forget today's \$2.50 Coke that used to cost a nickel). Medical services, health insurance and college tuition are also mind-numbingly more costly than in days of yore.

To fully comprehend how inflation works, remember one basic fact: The inflation rate can vary wildly from one year to the next (see Inflation Rate Chart on page 140),



Inflation-Fighting Tips

These tips can help you meet your retirement goals:

- Prepare a detailed and flexible plan for your retirement and keep it up to date as your circumstances change.
- Maximize your contributions. Contribute as much as you can as early as you can to your tax-deferred retirement plan. Allow the magic of compound interest to help counter inflation's effects.
- Resist the temptation to use your retirement portfolio as an emergency funding source. Cashing out a portion of your tax-deferred retirement plan will result in taxes and penalties that will put a serious dent in future growth.
- Include some equities in your retirement portfolio. Most experts agree that stocks historically offer the best opportunity to achieve a rate of return on investment that will outpace inflation.
- Invest in dividend-paying stocks that have a long payment history and a record of steady dividend increases.
- Invest a portion of your retirement portfolio in Treasury Inflation-Protected Securities (TIPS).

but regardless of the variations, inflation continues year after year. Even today's low inflation rate will take a significant toll over time; for example, that dollar bill in your pocket now will be worth only 82 cents in today's dollars after 10 years of 2% inflation. If you paid \$60 for a week's groceries in 1985, you're paying about \$106.48 for those same items today. If you paid \$15,000 for a new car in 1985, it will cost you approximately \$27,000 to replace it with a similar 2006 model; 10 years from now, a comparable new car will cost you about \$35,000 (assuming a modest 2.5% inflation rate).

These figures assume that the increases in costs for the items mentioned kept exact pace with the current rate of inflation. In practice, the inflated price of a specific good or service may be higher or lower than the average, so calculating inflation's effects over a period of two or more years can get dauntingly complex. That's why it's difficult to make simple dollar-to-dollar comparisons from one year to another. The only meaningful way to compare prices from one period to another is to compare them with the general price level of each period or to the percent of average wages necessary to pay for the item during each period. (To gauge inflation's effects on some of your personal expenses, log on to www.westegg.com/inflation/. This easy-to-use inflation calculator adjusts any given amount of money for inflation, according to the Consumer Price Index, from 1800 to 2005.)

How Much Income Will You Need?

Now that you have a clearer picture of how it works, what does inflation have to do with your retirement? Plenty. If you're closing in on your retirement years, you've probably already read several variations on how much income you'll need to maintain your life-

style. Many financial planners estimate that figure at 80% of your pre-retirement income. So, if your earnings are \$60,000 per year just before you retire, you'll need \$48,000 to maintain your lifestyle. If your annual income is \$100,000, you'll need \$80,000.

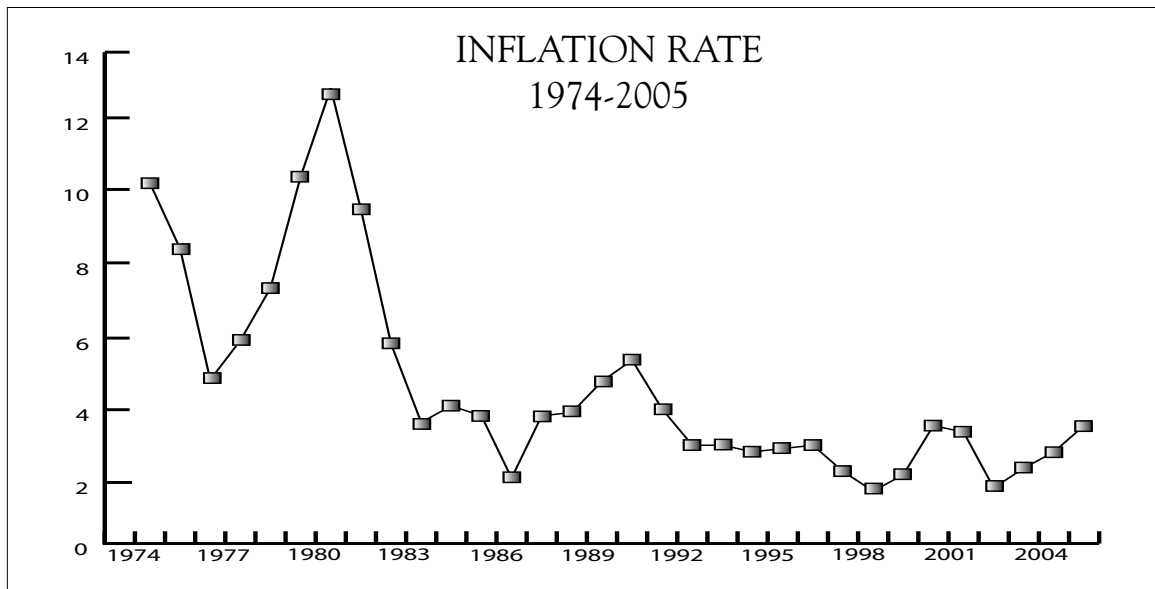
It sounds simple, but not all of the experts agree with this school of thought. Walt Woerheide, Ph.D., vice president of Academic Affairs at The American College in Bryn Mawr, Pennsylvania, believes that most people experience a significant drop in expenses when they retire. "Chances are your mortgage will be paid off, you'll no longer need to put aside money for savings and you'll have the time to do chores that you may have been paying other people to do," Woerheide says.

However, Dallas-based certified financial planner Carl J. Kunhardt claims his experience differs. "We're finding that clients are spending essentially the same amount after retirement as before. It's what they're spending money *on* that changes," he says. In spite of the disagreements over the best model for estimating required retirement income, the one thing that is clear is that many of the popular formulas fail to consider inflation—which is why *you* must.

Compensating for Inflation

There are several ways that you can compensate for the effects of inflation on your retirement nest egg. Obviously, no one can predict future inflation rates, so you'll have to estimate. Moreover, since it's unlikely that the current low rate of inflation will continue for much longer, you'll need to adjust your estimate of required retirement income to compensate for rates as they change. Financial consultant Ingrid K. Lamb, CPA/PFS, CFS, Chesapeake Beach, Maryland, notes

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The lower inflation rate in recent years makes it easy to forget its potential to spike as it did in the '70s and '80s.

that Social Security and some private pensions will normally be adjusted upward to help counteract the effects of inflation; however, retirees depending on investments for a significant part of their income may find that's not enough. "One way to compensate for inflation is to invest part of your portfolio in dividend-

paying stocks that have a long payment history and a record of steady dividend increases," says Lamb.

Maury Randall, professor of finance and department chair at Rider University in Lawrenceville, New Jersey, agrees that every retirement portfolio should contain some stocks as a hedge against inflation.

One of the best ways to account for inflation is to maintain a detailed financial plan for your retirement.

“Another method of protecting yourself is to invest in Treasury Inflation-Protected Securities (TIPS),” says Randall. “These U.S. Treasury bonds provide a return based on the cur-

rent rate of inflation, so when inflation rises, you’ll get a higher interest rate.” For more information visit TreasuryDirect (www.savingsbonds.gov), the U.S. Treasury website.

According to G. Mike Crawford, CFP, CEO of Lifeplan Financial Group in Dayton, Ohio, one of the best ways to account for inflation is to maintain a detailed financial plan for your retirement. “Without a road map, it’s difficult, if not impossible, to see where you’ve been and where you’re heading,” he says. Crawford believes that a retirement plan prepared by a CFP is the best choice for most people, but adds, “Either way, it’s important that your retirement plan is active and flexible.”

The Charles Schwab brokerage firm recently published a retirement planning rule of thumb that suggests that you’ll need \$230,000 in retirement savings in today’s dollars to provide \$1,000 in monthly income during retirement. For example, if you want to add \$2,000 per month to your Social Security income, you would need \$460,000 in retirement savings and investments—in today’s dollars. The key phrase is “in today’s dollars.” Even if you assume that today’s inflation rate will remain the same over the next 10 years, that \$460,000 in today’s dollars will be about \$555,264 in 2015 dollars. So if, for example, your retirement is 10 years away, you’ll need to increase the \$460,000 mentioned above to allow for the effects of 10 years’ inflation.

Regardless of the method you use for retirement planning, it’s important to take inflation into account. “No one else is going to worry about your financial health in retirement,” says Kunhardt. “If you hope to enjoy a comfortable retirement, you’ll have to arrange for it yourself.” ●

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