INFLATION RISK

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In my May 2007 article entitled *Longevity Risk,* I posed the question, "When you retire, should you live off a lump sum of money or the income stream produced by a lump sum of money?" Your answer to this question can have a significant impact on your future financial security. Before answering this question, it is imperative to understand inflation.

What is inflation? Inflation can best be defined with an example. Take a United States postage stamp. In 1985, it cost $0.22 to mail a one ounce letter. Today it costs $0.41. In 1985, $1.00 would buy you 4.54 postage stamps. Today $1.00 would buy you 2.44 postage stamps. This is inflation – the fact that it requires more money year after year to buy the same goods and services. So, how should it factor into your future financial planning? Allow me to provide a scenario for illustration.

Imagine for a minute you retired in 2000, had $1,000,000 in savings, and needed $60,000 per year to maintain your lifestyle. Your retirement plan consisted of investing your money in Certificates of Deposit (CDs) each year and living off the interest. In 2000 the U.S. short-term interest rate was 5.82% which would have provided pre-tax income for that year of $58,200. Close enough - but what about the next year?

From the stamp example above we know that if costs rise because of inflation you would need more money the following year, and each successive year, to maintain your lifestyle. In other words, if you want to buy the same number of stamps each year you will need a *larger dollar amount* to do it. Now fast forward to 2006. Over this seven year window, the inflation rate as measured by the Consumer Price Index (CPI) averaged 2.77%. Holding interest rates constant, this means the $58,200 of pre-tax income you received in 2000 would only buy $47,799 of goods and services in 2006. Therefore, throughout retirement you will most likely need to have a growing pool of money to be able to produce your growing income need (unless you do not mind spending down your principal and running the risk of outliving your money).

In the past, retirement was referred to as your "golden years." This can continue to be true as long as you properly plan for and execute a strategy to maintain the buying power of your money (i.e., your lifestyle).

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Sources:
U.S. Postal Rates Historical Chart; www.measuringworth.com; www.bls.gov/cpi