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How Inflation Impacts Your Financial Planning

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Inflation is the increase in prices you pay for the same products in the future, whether we are discussing a tangible item or a service. The government calculates what a basket of "things" for the average consumer would cost. They use a baseline of a certain year at a fixed value. Then they compare the same prices for the same things (housing, medical service, food, gasoline, etc.) in year two and note what percent the prices went up. This is the measure of inflation we hear of as the CPI or Consumer Price Index.

The Variables

Note the variables that can affect what is measured as inflation. Some products can get both cheaper and better. For example, in the future you will spend less on many technology goods compared to now or five years ago, even though they may be faster and better products. Another variable is what exactly goes into the basket of goods that is measured. Some of us utilize the measured goods more than others. If healthcare is a large part of the basket, then the elderly might be more represented. Meanwhile, educational costs would not affect the elderly very much. The cost of childcare would of course be reflected more for young families. So the inflation numbers do not affect all groups in the same way – they are just a large conglomerate effort. (For more, see: *Achieve Your Financial Goals With a Financial Plan*.)

Note also that inflation (the CPI) is reported monthly, but can vary on a seasonal basis. The year-over-year number is more valuable. Also, often food and energy are separated out from the general CPI due to the volatility of these factors. Housing in particular is a large percentage of the CPI basket and is split between owner's costs and rental costs. So the take home message is that changes in the CPI should be accepted with the knowledge that every family "sees" a different amount of inflation. It is also important that the government has some leeway in deciding how to report the CPI.

But, all things considered, the CPI is a reasonable way to see how quickly our purchasing power is eroding. For this is certainly happening, as it takes more dollars to buy the same basket of products with every passing year. Also note that inflation has become "normal." The last real time we did not have inflation was during the Great Depression over 80 years ago. (For more, see: *7 Tips for Year-End Financial Planning*.)

Impact on Portfolios

If we hold cash currently with its sub 1% interest yield and inflation is considered at 3%, we are losing almost 3% a year in purchasing power for the cash we hold. As an example, it will take almost 20% more in dollars five years from now to buy the same product as today. So our retirement portfolios must keep up with inflation (and taxes) if only to keep up the same purchasing power year after year. Over the last 50 years, inflation has averaged about 3%, so a portfolio must "make" this 3% plus any tax costs just to break even year after year.

Also, the value of a pension stream of income that is not adjusted for inflation (and most annuities) will buy significantly less in the future than now. Inflation is a powerful reducer of wealth over time. It must be considered carefully in your financial plan. (For more, see: *The 3 Most Important Tips for Your Financial Plan*.)

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