



The Effect of Inflation on Your Retirement

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Planning for retirement is complex. It is almost impossible to account for all the potential variables that retirees are likely to face throughout their retirement journey.

One factor many people fail to address in their retirement plan is the effect of inflation on their purchasing power. Inflation can silently kill the best-laid plans and gradually erode your quality of life. Omitting this crucial aspect from your plan is a sure recipe for becoming destitute later in retirement.

Inflation is the increasing cost of goods and services that inevitably affects a growing economy. We have all experienced it firsthand. What did you pay for a movie ticket when you were a kid? How much was a gallon of milk 20 years ago? In 1978, the national average price for a gallon of gas was 66 cents. Today, it is around \$3. That is more than a 450 percent increase. If you retired at 55 in 1978 and did not account for an annual increase in prices, could you stick to the \$33 a month you budgeted for gas back in '78? You could cut back on your driving, but what about the price of bread, property taxes, or healthcare costs. They can't be avoided.

Inflation affects all prices, just at different rates. We have seen the volatility in gas and food prices during the past few years. Healthcare costs are growing at an average annual rate of more than 5 percent. This is frightening when faced with the prospect of this being your biggest single cost 20 years from now.

Inflation is measured by the government through a statistic known as the Consumer Price Index (CPI). The CPI is attained by tracking a basket of goods and services and measuring their price changes. This is the best indicator we have to determine where inflation has been and where it is likely to go.

When measured over a long period, the CPI averages about 3.5 percent. This means that, on average, a basket of goods increases in price 3.5 percent annually. So, when we begin budgeting our retirement costs, it is important that we factor in a yearly increase in expenses between 3 percent and 4 percent. This "raise" a retiree gives herself every year should offset price increases of goods and services.

Many people question whether this adjustment is enough to cover their costs given that most retirees spend more on medical costs as they age and that medical costs are increasing at a greater rate. The 3-to-4 percent rate should be sufficient for almost all retirees because when a worker retires at 65, their first few years are filled with travel, entertainment, and meals out. But as they age, their ability to have or desire for this lifestyle diminishes. Most 80-year-olds don't travel like they did at 65, usually for health reasons. The money that was spent earlier in retirement on recreation can be shifted to health care if the inflation adjustment is insufficient.

To account for inflation, you must draw less from your portfolio than you might otherwise do. This will allow your portfolio to grow and offset inflation. For instance, if

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you had decided that your portfolio should average a return of 8 percent per year during retirement, it makes sense to live off only 4 percent of that portfolio annually. Every year, a portion can be reinvested to allow the portfolio to grow and offset inflation. Using this strategy, not only will it be extremely unlikely that you will ever run out of money, but you will be able to provide your income with an inflation adjustment each year.

Let's assume you have a \$1 million investment portfolio earning on average 8 percent annually. In Year One, you withdraw \$40,000 on which to live. In Year Two, you adjust your withdrawal 4 percent to account for inflation. So in Year Two, you withdraw \$41,600. In Year Three, you withdrew \$43,264 and so on. If you were retired for 30 years, your last withdrawal would be \$129,735. That may seem like a lot of money, but in 2038, if a gallon of milk is

\$12.50, you will need every bit of your income to maintain the same lifestyle as in Year One.

Inflation adjustment of income may not be a hot topic in financial circles these days, but to those who are not properly accounting for it; it can be their most pressing challenge. Prices will continue higher regardless of your situation. Living on a fixed income that does not adjust is like smoking cigarettes. One may not matter much, but string years and years of smoking together, and you are at high risk for big problems. Good financial planning early can prevent large and terrible problems later.

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