

Inflation: The Silent Threat to Your Long-Term Financial Security

While most investors are rightfully pleased with rising growth projections at home and abroad, the recovering global economy brings with it the specter of inflation. The dreaded “I” word has cropped up increasingly in recent months, largely due to the rapidly escalating price of commodities—particularly oil.

The Current Situation

The recent overthrow of governments in Tunisia and Egypt and ongoing unrest in Libya, Bahrain, Yemen, Iran, and Algeria have sent oil prices soaring above \$100 a barrel, their highest level in more than two years.¹

And consumers are feeling the pinch at the pumps. According to the U.S. Energy Information Administration, the national average retail price for regular grade gasoline increased 19.4 cents, to \$3.38 per gallon, in the seven days between February 21 and February 28, 2011. This spike marked the second largest one-week increase since 1990. Again, between March 7 and March 14, retail gas prices rose another 4.7 cents per gallon.

Where the current upward spiral in oil and other commodity prices will end is anyone’s guess. But one thing is clear. Over time, inflation can erode your purchasing power, which means that your dollar will buy less tomorrow than it does today.

Inflation Under the Microscope

Just what is inflation, this ravenous beast that eats away at the value of every dollar you earn? It is essentially the increase in the price of goods and/or

services. The most commonly referenced measure of that increase is the Consumer Price Index (CPI), which is based on a monthly survey by the U.S. Bureau of Labor Statistics. The CPI compares current and past prices of a sample “market basket” of goods from a variety of categories, including housing, food, transportation and clothing. The CPI does have shortcomings, however, according to economists. For instance, it does not take taxes into account or consider that as the price of one product rises, consumers may react by purchasing a cheaper substitute (name brand vs. generic, for example). Nonetheless, it is widely considered a useful way to measure prices over time.

Despite the recent, severe spike in the cost of gasoline, inflation has remained quite tame for the past 30 years or so, hovering around 3%.² At that low rate, many people understandably overlook inflation when preparing for their financial future. After all, 3% might not seem to be worth a second thought—until you consider the impact it can have on the purchasing power of your money over the long term. For example, after 30 years, an annual inflation rate of 3.0% could drive the value of today’s dollar down to the equivalent of \$0.41.³

Inflation and Your Investments

Inflation also works against your investments. When you calculate the return on an investment, you need to consider not just the interest rate you receive, but also the real rate of return, which is determined by figuring in the effects of inflation. Your financial advisor can help you calculate your real rate of return.

Clearly, if you plan to achieve long-term financial goals, from college savings for your children to your own retirement, you will need to create a portfolio of investments that will provide sufficient returns after factoring in the rate of inflation.

Protecting your portfolio against the threat of inflation might begin with a review of the investments that may help provide returns that outpace inflation.

Over the long run— 10, 20, 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 holding periods between 1926 and December 31, 2010, found that the annualized return for a portfolio composed exclusively of stocks in Standard & Poor's Composite Index of 500 Stocks was 9.93%—well above the average inflation rate of 3.01% for the same period, while the annualized return for long-term government bonds was only 5.53%.⁴

A Balancing Act

Keep in mind that stocks do involve greater risk of short-term fluctuations than other asset classes. Unlike a bond, which guarantees 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.

rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Investing in stocks involves risks, including loss of principal.

¹Source: Standard & Poor's, *U.S. Financial Notes*, February 25, 2011.

²Source: The Bureau of Labor Statistics.

³Sources: The Bureau of Labor Statistics; Standard & Poor's.

⁴Sources: Standard & Poor's; Barclay's Capital. Stocks are represented by the total annual returns of the S&P 500, an unmanaged index that is generally considered representative of the U.S. stock market. Other risks inherent to investments in stocks include the fluctuation of dividend, loss of principal, and potential illiquidity of the investment in a falling market. Bonds are represented by the total annual returns of the Barclays Long-Term Government Bond index, a broad-based index that is generally considered representative of the U.S. bond market. Inflation is represented by the annual change in the Consumer Price Index. It is not possible to invest directly in an index. Past performance is not a guarantee of future results. The performance shown is for illustrative purposes only and is not indicative of the performance of any specific investment. Bonds are subject to market and interest

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