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INFLATION AFFECTING
RETIREMENT PLANNING
June 15, 2023
Shepherd
FINANCIAL

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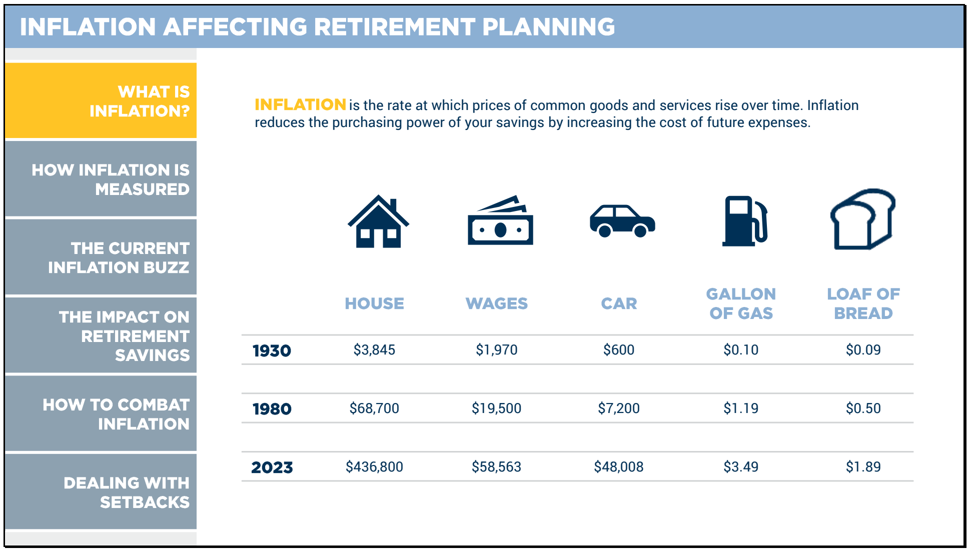

It is great to have you here, because our topic today has been on many people's minds. How is inflation going to impact my retirement planning and savings? We want to address that by explaining just what inflation is and how it's measured, what's sort of led us to this point over the past couple of years, how inflation could impact you, and what you can do to combat it.

Inflation is the rate at which prices of common goods and services rise over time. It reduces the purchasing power of your savings by increasing the cost of future expenses. In simple terms, inflation is the decline of your money's purchasing power – in our case, a dollar buys less now than it did in the past. And this loss of purchasing power impacts the general cost of living for the general public. It's important to note, though, that inflation isn't inherently a good or bad thing. Moderate and steady inflation is critical to a healthy economy – rising prices encourage consumers to buy now rather than later, which keeps demand up. At the same time, we know temporary spikes in inflation can be unsettling.

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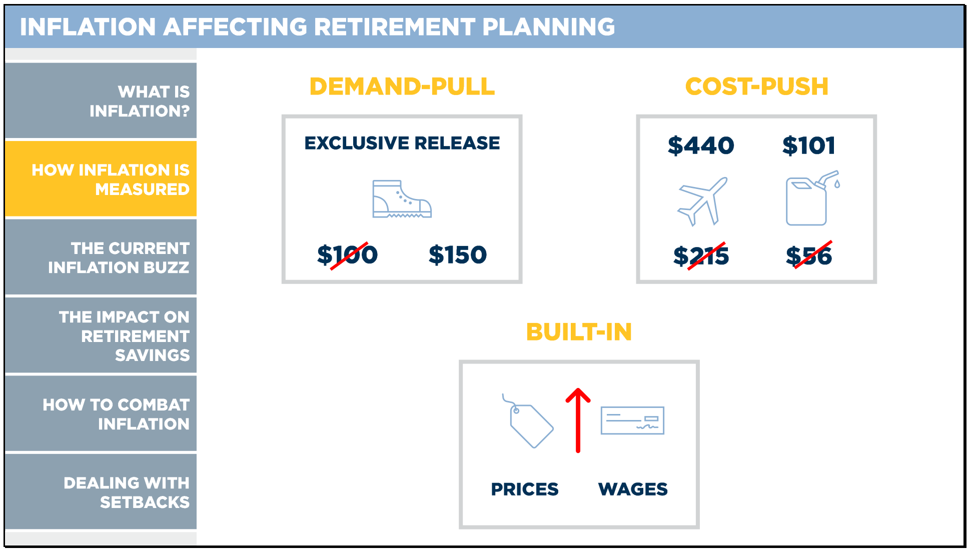

So the government measures inflation by comparing the current prices of a set of goods and services to previous prices. But the math of it all is actually more complicated than it sounds. While it's easy to measure the price changes of individual products over time, our needs extend beyond just one or two products, right? We use a broad range of products, as well as many different services for living a comfortable life. The Consumer Price Index, or CPI, is produced by the Bureau of Labor Statistics and is the most widely used measure of inflation. It's designed to measure price changes faced by urban consumers who represent about 93% of the US population. But keep in mind: it's an average and doesn't reflect any particular consumer's experience. The CPI is constructed each month using 80,000 items in a fixed basket of goods and services. These include commodities such as food, metal, fuel, electricity, transportation, healthcare, entertainment, and labor. The different prices are weighted according to how important they are to the average consumer. It's probably no surprise that Americans spend more on chicken than they do on tofu, so changes in the price of chicken have a much greater impact on the CPI than tofu does.

As you can see on the screen, there are three basic types of inflation. The first is demand-pull inflation, which occurs when the demand for goods or services exceeds the production capacity. You see this a lot with limited release items, like an athlete's signature shoe. But there is also cost-push inflation, which is when production costs increase prices. For example, if oil prices go up, you might pay more for airplane tickets. And then there is built-in inflation. This means when prices rise, wages rise, too, in order to maintain living costs. This is the expectation that inflation will continue to rise in the future.

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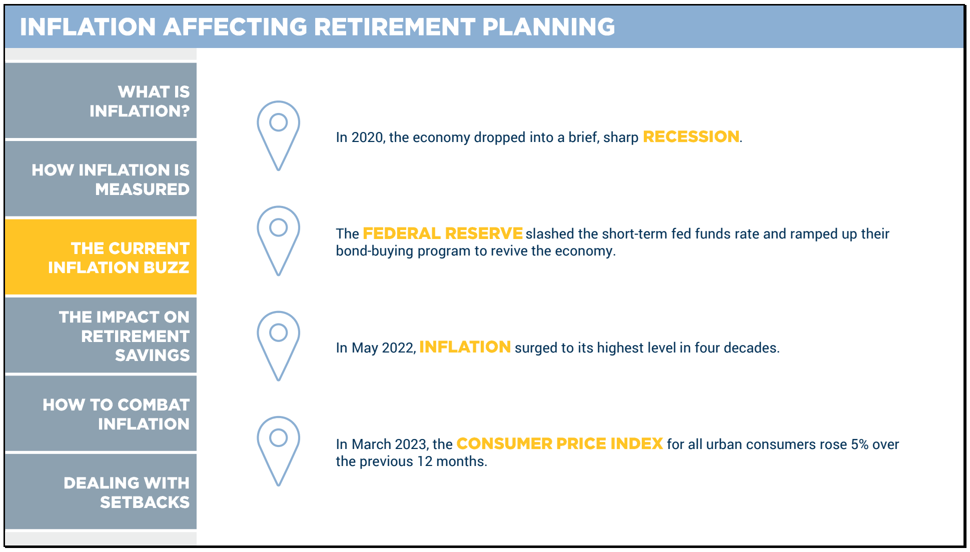

I think we are all pretty aware that some big things have happened in the past few years. In 2020, the economy dropped into a brief, sharp recession. In response, the Federal Reserve, whose job it is to fight inflation and keep the economy growing, slashed its key short-term fed funds rate to near zero. In addition, they ramped up their bond-buying program to revive the economy. But the hits kept on coming. In 2021, a surge in consumer spending, combined with higher oil prices and persistent supply shortages and an increase in prices, pushed inflation well above the Fed's 2% target. In fact, in May of 2022, inflation surged to its highest level in four decades. And as we just discussed, rising inflation means your dollar has less purchasing power – everything you buy is more expensive. I just mentioned the Federal Reserve typically sets monetary policy to target an inflation rate of about 2% per year. Lately, though, the rate of inflation has been significantly higher than the average: in March of this year, the CPI for all urban consumers rose 5% over the previous 12 months.

And in order for the Fed to achieve their goal inflation rate of 2%, they have to raise interest rates. That helps slow down the economy, which is a good thing in this case. By making borrowing more expensive, consumers, investors, and businesses pause their buying – this reduces demand in the US economy and, theoretically, reels in prices. This helps balance the supply and demand scales, which were one cause of inflation thrown out of whack by the pandemic.

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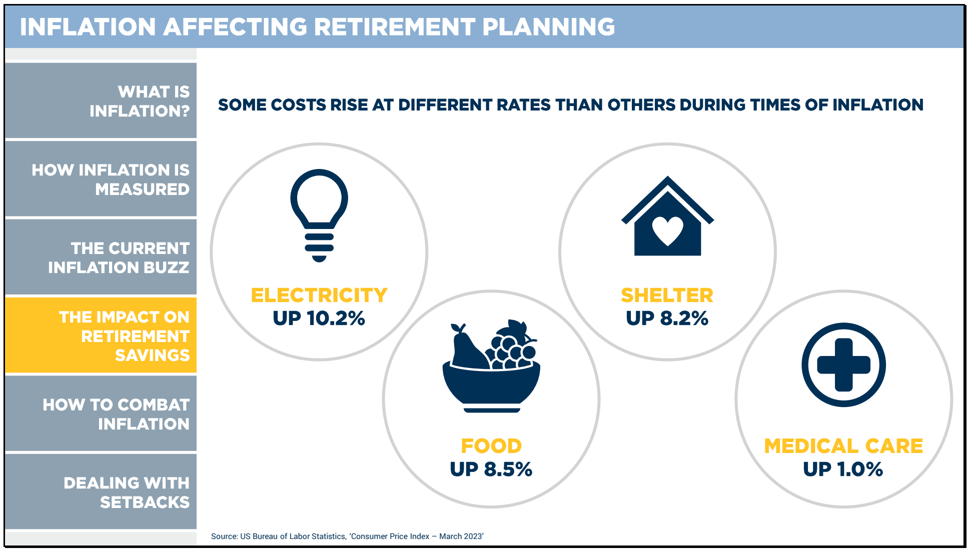

All right, so now that we have a basic understanding of what inflation is and how it's measured, let's talk about how it can impact our retirement savings. Inflation is often unpredictable, so it can be an important factor to account for when planning your retirement income strategy. If inflation persists at a high level or gets out of control, it can eat away at your purchasing power – what you can buy with the money you have. The same product that cost $2 six months ago might now cost $4 due to inflation. Rising prices could produce a gap between your planned income and what is actually required to pay your bills. And if you need to withdraw a higher amount from your retirement savings over time, that activity could affect the long-term sustainability of your retirement income plan.

What about the cost of medical care services? These costs are particularly important to plan for in retirement and have risen significantly in recent decades. However, as you can see on the screen, at only 1%, these costs rose at a slower rate than overall inflation over the 12 months through this past March. That's pretty interesting. But it doesn't mean you can ignore these costs. Health care continues to be one of the largest expenses in retirement: it's estimated that about 15% of the average retiree's annual expenses will be used for health care-related expenses, including Medicare premiums and out-of-pocket expenses. Keep in mind that the average retirement age is 62 for most Americans, and that's three years before you're eligible to enroll in Medicare.

Since many of you are participants in our plans, I'm sure you're wondering, 'How will inflation impact my 401(k) account?' Just like we talked about inflation making your purchasing power decrease, it means it costs more to buy the stocks and other investments in your retirement plan. Not only that, but consider this: if inflation rises to, say, 8.5% and your investments hypothetically return 9%, your net gain is only 0.5%. That’s right. Rising inflation means your investments have to work harder to keep pace.

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Let’s dig into the action plan! First of all, good financial habits like budgeting and diligent saving are critical to thriving in difficult economic circumstances. An effective retirement strategy relies on an accurate estimate of what a household actually spends. That value is likely to change from year to year in a high-inflation environment, so it requires regular updating. The next thing is to create a plan. Your retirement strategy can plan for the possibility of temporary spikes in inflation. Many advisors assume a long-term inflation rate of 3%, because it sits in the middle of the Fed’s target rate and recent inflation, so it’s a helpful average.

Your investment plan has a big role in combatting inflation. And while it can feel a little scary during times of market volatility or inflation spikes, think about it like this: you are investing in yourself. So maintaining or even increasing your retirement savings rate can help ensure the success of your plan. Now, we have talked about how cash can’t keep up with the pace of inflation – we want to channel the power of compound interest, and that means starting early and continuing to invest. Everyone’s situation is unique, of course, but consider your allocation to stocks – stocks have historically averaged annual returns well in excess of average inflation. This makes owning stocks in your retirement portfolio one of the most effective tools available to protect your savings from sustained inflation. Of course, the relatively higher long-term returns offered by equity investments come with higher short-term risks. So portfolios typically offset some of this short-term market risk by allocating a portion of the savings to bonds, which generate income more consistently. Bond investments may not offset inflation, however, and their value decreases when interest rates rise. And remember that diversification does not guarantee a profit or protect against a loss.

What else should investors consider in their portfolio? Managing long-term growth with near-term income needs makes it very important to regularly revisit your plans and also highlights the value of having a cash cushion. Yes, even though inflation reduces the spending power of cash on hand over time, having enough available to cover unavoidable emergency expenses means you can limit the amount you need to withdraw from your longer-term investments. As we are considering the impact of inflation on your broader financial plan, I want to touch on Social Security. We've told you in the past that it's important to work with an advisor to figure out the best timing for you and your situation. If you're eligible but haven't claimed Social Security benefits yet, remember those benefits are adjusted for inflation, which could make waiting even more attractive. Every year, Social Security recipients are eligible for a cost-of-living adjustment, or COLA. The increase in benefits is designed to help beneficiaries keep up with rising prices. The amount of the increase can vary greatly from year to year, and there's guarantee of an increase in any given year. Over the past 20 years, the COLAs were mostly modest, averaging around 2% each year, but the past two years have had more significant increases due to surging prices in food and fuel.

How would we address healthcare costs? Two thoughts for you here: long-term care insurance and annuities with increasing lifetime income riders. Long-term care insurance may be a solution to the gap between what Medicare covers and your actual long-term care needs. A long-term care policy with automatic inflation protection, sometimes called an automatic benefit increase rider, increases your long-term care insurance benefits automatically each year. You can choose between simple inflation protection or compound inflation protection. Simple inflation protection is interest on your original daily benefit only. For example, if you get 5% simple interest on a daily benefit of $200, it will increase by $10 per day on each policy anniversary. So if your benefit at age 55 was $200, your benefit at age 80 would be $350. And compound inflation protection is interest on interest, not just the original daily benefit. So if your benefit at age 55 was $200, at age 80, it would be $677. An annuity is a financial product that provides a guaranteed income stream for a fixed period or life. Annuities with increasing income riders are a type of annuity that provide a guaranteed income stream that increases over time to keep up with inflation. And that income stream can start immediately or be deferred until a later date. Choosing the right annuity can be complex, so working with a financial advisor who is knowledgeable in annuities and retirement planning is essential. They can help you understand the pros and cons of different annuity options and then help you make an informed decision based on your financial goals and needs.

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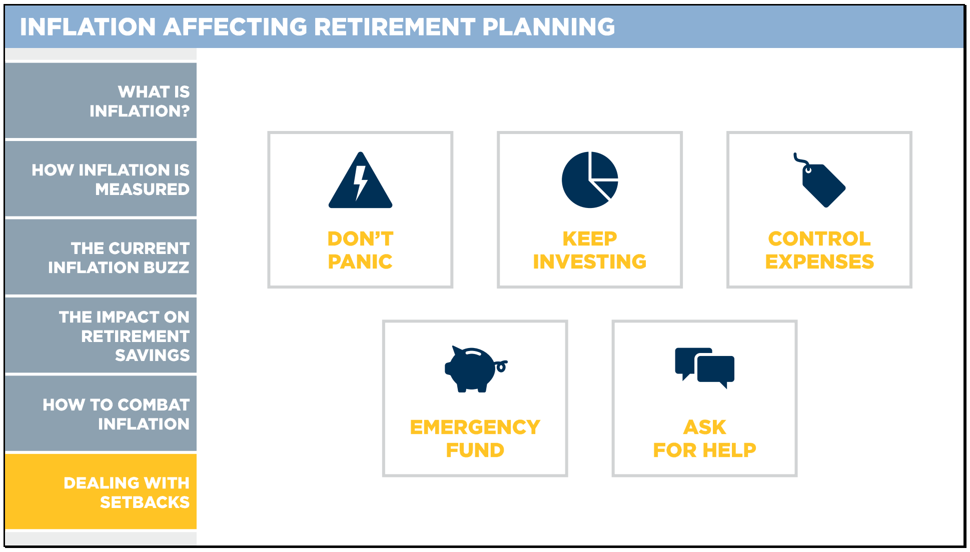

Let's wrap up today by talking about how to deal with setbacks. They happen to all of us. It's true, and they're not always our fault. So the first thing I will say is 'Don't panic!' Market volatility is normal. Inflation is normal. There is a path forward. That's right. And then keep saving through periods of high inflation and investing through the uncertainty. Review your budget and consider ways to adjust your spending over the short-term to help balance out the bumps. You might find ways to cut costs and control expenses, like conserving energy usage. Or you may have to trim some discretionary expenses in your budget – that may involve downsizing or foregoing a planned vacation or home renovation. If you think some of the price hikes might be temporary, consider delaying a big purchase. And in retirement, you might think about picking up part-time work to help close the income gap. We've said it before, but that emergency fund and healthy cash position are so helpful in covering one to two years' worth of expenses early in retirement, especially if periods of inflation coincide with declines in the market value of your investments. And of course, if you use planning tools or work with a financial professional carefully consider the right inflation assumptions to use going forward. If you don't currently work with someone, think about it! Give our team a call to see what financial moves might be right for you. We are always happy to have that conversation.

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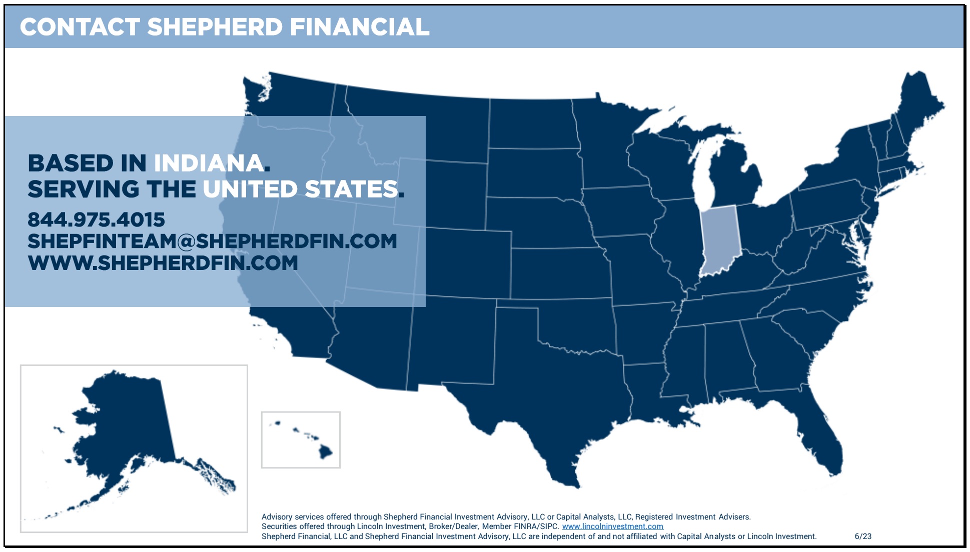

If you'd like to chat with one of our team members, you can always call us at 844.975.4015 or 317.975.5033. Please don't hesitate to reach out for help!

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DEFINITIONS AND DISCLOSURES

Investments in Target Date Funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. The principal value in a Target Date Fund is not guaranteed at any time, including on or after the target date, which is the approximate date when investors turn age 65. Should you choose to retire significantly earlier or later, you may want to consider a fund with an asset allocation more appropriate to your particular situation. The funds invest in a broad range of underlying mutual funds that include stocks, bonds, and short-term investments and are subject to the risks of different areas of the market. The funds maintain a substantial allocation to equities both prior to and after the target date, which can result in greater volatility. All investing is subject to risk, including the possible loss of the money you invest. Investments in bonds are subject to interest rate, credit, and inflation risk.

Investing involves risk including the potential loss of principal. No investment strategy can guarantee a profit or protect against loss in periods of declining values. There are some risks associated with investing in the stock markets: 1) Systematic risk - also known as market risk, this is the potential for the entire market to decline; 2) Unsystematic risk - the risk that any one stock may go down in value, dependent of the stock market as a whole. This also incorporates business risk and event risk; and 3) Opportunity risk and liquidity risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. An investment concentrated in sectors and industries may involve greater risk and volatility than a more diversified investment. Small and mid-cap stocks may be subject to a higher degree of risk than larger, more established companies' securities, including higher risk of failure and higher volatility. The illiquidity of the small and mid-cap markets may adversely affect the value of these investments so those shares, when redeemed, may be worth more or less than their original cost. In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities).

Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate. Treasury bills (T-bills) are short-term securities with maturities of one year or less issued at a discount from face value. Treasury bills are the primary instrument used by the Federal Reserve in its regulation of money supply through open market operations. Treasury notes (T-notes) are intermediate securities with maturities of 1 to 10 years. Denominations range from $1000 to $1 million or more. The notes are sold by cash subscriptions, in exchange for outstanding or maturing government issues, or at auction. Treasury bonds (T-bonds) are long-term debt instruments with maturities of ten years or longer issued in minimum denominations of $1,000. Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Actual investment return and principal value of a mutual fund investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Compounding is the ability of an asset to generate earnings, which are then reinvested in order to generate their own earnings (generating earnings from previous earnings).

Asset allocation and diversification do not guarantee a profit or protect against loss.

Past performance is no guarantee of future results. No person or system can predict the market. All investments are subject to risk, including the risk of principal loss.

Consult your financial professional before making any investment decision.