

# Inflation in Retirement

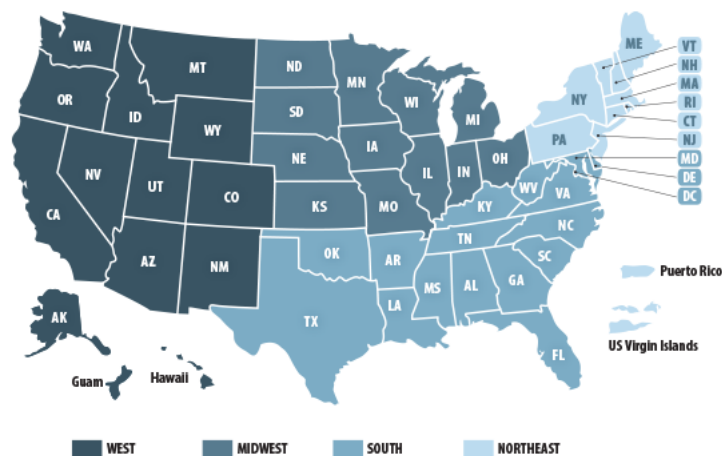
**As clients prepare for and enter retirement, several factors need to be evaluated to ensure a successful and sustainable retirement lifestyle. One of the factors that must be considered is the long-term effect of inflation. However, while many clients and financial professionals assume they understand inflation, it tends to be a very nuanced issue. Specifically, inflation is often treated as a uniform experience and a constant. As a result, the impact of inflation on a retirement income strategy can create outcomes that are neither accurate nor dependable.**

## UNDERSTANDING INFLATION

Inflation, simply put, is the rising cost of goods and services over time. These increasing costs decrease the purchasing power of money as inflation rates increase. The Consumer Price Index (CPI), as calculated by the Bureau of Labor Statistics (BLS), is the method by which inflation is generally calculated and reported. It should first be noted that the CPI is not a percentage, as often reported in the media. Rather, the CPI is an index value measuring the price of a basket of goods. It is the percentage change in the index values that is used when reporting an "inflation rate." However, by using the percentage change in the CPI as reported by the media, without accounting for the CPI's nuances, many strategies will not account for inflation's real impact on clients.

To start, consider how most people understand inflation. In 2020, the CPI increased 1.4%.<sup>(1)</sup> However, that reflects the national average. During that same time, the United States experienced significant regional variations in the CPI.

The BLS divides the United States into four regions. Each region measures the prices in that region for the basket of goods that are used to calculate the CPI.



Based on the data compiled by the BLS, each region of the United States consistently experiences different rates of inflation. For example, in 2020, the Midwest region experienced an increase of 1.1% in the CPI. Meanwhile, the West region's increase in the CPI during that same time was 42% higher than the Midwest region, reporting a 1.7% increase in the CPI.<sup>(2)</sup> The key takeaway is that not everyone experiences inflation the same way. It depends on where you live. Using the national average can significantly under- or over-report the actual inflation rate for a given region.

Additionally, there are multiple versions of the CPI. Each variation of the CPI uses different weightings to measure the impact of price changes for a particular population. For example, the CPI-U focuses on urban consumers and covers approximately 93% of the total population. The CPI-U is the most often cited version of the CPI. The CPI-W focuses on workers and covers 29% of the population. Somewhat ironically, the CPI-W is what is used to calculate cost-of-living adjustments to Social Security. And the CPI-E focuses on households over the age of 62. The CPI-E represents approximately 24% of the population.<sup>(3)</sup>

As you can see in the chart<sup>(4)</sup> below, the different CPIs weigh the baskets differently.

	CPI-U	CPI-W	CPI-E
Food	15.16%	16.65%	13.52%
Housing	42.39%	40.87%	46.57%
Clothing	2.66%	2.30%	1.89%
Transportation	15.16%	16.85%	12.97%
Medical Care	8.87%	7.59%	12.20%
Recreation	5.80%	5.22%	5.44%
Misc. and Other	9.96%	10.52%	7.41%

The different weightings can have a significant impact on how inflation is reported. Consider medical care. The CPI-E's medical care weighting is approximately 38% higher than it is for CPI-U. Yet, food is nearly 11% lower in the CPI-E than it is in the CPI-U calculation. Such differences can result in statistically significant differences in inflation rates.

### DIFFICULTIES IN MEASURING INFLATION

The CPI is by no means perfect. There are a number of limitations in how the BLS calculates inflation. For example, while there are regional variations of the CPI, there can be significant variations within a region. For example, the West region includes California as well as Wyoming. In the past 10-years, according to the Federal Reserve, the price of housing in California has increased 107%.<sup>(5)</sup> Meanwhile, the price of housing in Wyoming has only increased 49%.<sup>(6)</sup> And while the BLS attempts to account for such variations, it cannot do so in a way that accurately reflects inflation without averaging, weighting, or making certain assumptions.

Additionally, the CPI cannot account for substitution bias. The CPI is a fixed basket of goods. It, therefore, cannot account for changes in consumer behaviors based on changes in prices. For example, if beef prices increase, individuals may switch their purchasing habits and begin substituting chicken for beef. There have been attempts to take consumer behavior into consideration. Chained-CPI is one such attempt. However, Chained-CPI is controversial and is not widely reported.

Furthermore, the CPI also does not account for personal preference. For example, while the CPI measures transportation, gasoline is one of the components within transportation. Individuals who have elected to purchase an electric vehicle would clearly not feel the same impact of changes in gasoline prices as someone who drives a less fuel-efficient vehicle. Similarly, the CPI places weightings on food prepared at home versus food purchased in a restaurant. Individuals who rarely eat out or who eat out frequently would experience changes in food prices differently.

Perhaps the biggest limitation of the CPI is its inability to build baskets of goods that can withstand changes in the marketplace. Consider the cost of a smartphone. Assume that the price of a smartphone today is \$1,000. If inflation is assumed to be 3%, the cost of a smartphone one year from now will be \$1,030. Ten years from now, assuming 3% inflation, the cost will be \$1,344. The calculation is simple math. We can project the cost of a smartphone 10, 20, or even 50 years from now if we assume a particular inflation rate.

But to understand how absurd our assumptions can get, consider how much a smartphone cost 20 years ago. Simply put, smartphones did not exist 20 years ago. The point is that while we make assumptions about the price of goods in the future, the goods we are making assumptions about may not even exist today. Conversely, the CPI still tracks the price of firewood. But when was the last time most individuals heated their home with firewood?

The key is that when we build out retirement income strategies that account for inflation, we are making assumptions about inflation and what it will look like for decades to come. And we are doing that based on our assumptions about inflation shaped by our current experiences, which may be far different from what the future may hold or what we may have experienced just a few decades past.

### **FORECASTING INFLATION AND ASSUMPTIONS**

Since 1960, inflation, as measured by the CPI-U, has averaged 3.7%. As a result, it can be tempting to assume a 3% or 4% inflation rate in a retirement strategy. But, since 1960, there have been periods of time where inflation has been greater or less than the 3.7% average. For example, during the 20-year period between 1970 and 1989, inflation averaged 6.3%. Conversely, during the 20-year period between 1990 and 2009, inflation averaged 2.7%. And inflation has been difficult to predict. In 2020, the inflation rate was a mere 1.4%. Yet it was followed by a spike in 2021 where inflation was 7%.

The key is that predicting inflation over a 20- or 30-year time period has been notoriously difficult. Economic conditions, political climates, national debt, market trends, labor markets, and even demographics will all impact future inflation rates. Yet, many financial professionals will make assumptions about inflation rates 20, 30, or even 40 years in the future.

To illustrate the danger of making such long-term assumptions about inflation, consider what a 1- or 2-point percentage difference in experienced inflation versus assumed inflation will have on an individual's standard of living. Assume an individual today requires \$50,000 a year to maintain their standard of living. If inflation is assumed to be 3% per year, the \$50,000 will need to double to \$100,000 every 24 years to maintain the same purchasing power. However, if the experienced inflation is 5% per year, the income would need to double every 14.4 years. Or, to put it another way, if inflation was assumed, and planned, to be 3% but was 5%, after 14 years, the individual would only have 76% of the necessary funds required to maintain their purchasing power.

### **WHAT'S THE SOLUTION?**

As clients prepare and plan for retirement, there are many considerations and risks. Inflation risk is one of the factors that must be considered to plan for a successful retirement. But it should be noted that inflation may be different for every client. As a result, care must be given when modeling inflation, as inflation has traditionally been very difficult to predict over long periods of time. And while every client situation is different, an annuity with increasing income can be one potential solution that financial professionals may wish to consider when tackling inflation risk.

Additionally, it becomes important to consider what inflation hedges a client already may have in their retirement income arsenal. For example, Social Security has a built-in inflation hedge as Social Security benefits receive Cost-of-Living Adjustments (COLAs) tied to the CPI. Many public pension plans have similar COLAs built into their plans as well. But for many, this may be where the list ends.

The result of such limited inflation hedges means that financial professionals need to look for ways a client's retirement nest egg can account for rising costs. And while there are several tools available, clients looking for inflation solutions that can also provide a lifetime stream of income may wish to consider the use of annuities that provide for increasing income.

Today, most income riders attached to deferred annuities and single-premium immediate annuities provide a guaranteed amount of lifetime income. The level of income does not change. As a result, if the annuity generates \$10,000 per year, that amount will remain unchanged for the client's life. This is similar to many private pension plans, as well.

However, annuities do exist that feature an opportunity for increasing income. In the case of a fixed index annuity (FIA), the increasing income can be tied to the performance of an underlying index or even the CPI. For example, if the index, subject to an FIA's cap, participation rate, or spread, were to increase by 4%, the income generated by the income rider would increase by 4%. Today, many carriers offer product designs that offer the potential for increasing income. These features take many shapes, so care must be given to understand the specifics of a particular product fully.

## CONCLUSION

As clients prepare and plan for retirement, there are many considerations and risks. Inflation risk is one of the factors that must be considered to plan for a successful retirement. But it should be noted that inflation may be different for every client. As a result, care must be given when modeling inflation as inflation has traditionally been very difficult to predict over long periods of time. And while every client situation is different, an annuity with increasing income can be one potential solution that financial professionals may wish to consider when tackling inflation risk.

<sup>(1)</sup> <https://www.bls.gov/charts/consumer-price-index/consumer-price-index-by-category-line-chart.htm>

<sup>(2)</sup> <https://www.bls.gov/cpi/regional-resources.htm>

<sup>(3)</sup> <https://www.bls.gov/cpi/overview.htm>

<sup>(4)</sup> <https://www.bls.gov/cpi/tables/relative-importance/2020.htm>

<sup>(5)</sup> <https://fred.stlouisfed.org/series/CASTHPI>

<sup>(6)</sup> <https://fred.stlouisfed.org/series/WYSTHPI>

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