How to Deal With Inflation Risk in Retirement

If there is one issue that retirees don't pay attention to, it is the inflation rate. Every year, the purchasing power of your money is eroded by the rate of inflation. So every time you are quoted the return on your investment, always deduct the rate of inflation to get the real rate of return. For example, the inflation rate may be 3% and the rate of return promised on an investment is 5%, essentially the return on the investment is 2%. So, always ensure that your money is growing at a rate higher than the inflation rate, and for a person who is about to or has retired, the risk is even higher. The following article by Robert Powell explains the effects of inflation on the investment funds of a retirement plan

In 1960, the median value of a home in the U.S. was $11,900. Today, some 50 years later, you'd be hard pressed to buy a decent car for that amount given that the average price in 2010 was close to $30,000. And in 50 more years, you might find it impossible to buy a car for $170,000, which was the median sales price of a single-family home in the U.S. in 2010.

And that, my friends, is inflation — one of the most insidious risks Americans will face in retirement. Yet despite years of witnessing firsthand the insidious effects of inflation, many Americans are not taking into account the adverse effects inflation can have on their retirement plans. Or at least so says some recent research just published by the Society of Actuaries (SOA).

Compared to other planning activities, only 72% of pre-retirees and 55% of retirees are calculating the effects of inflation on their retirement planning, according to the SOA's report (http://us.lrd.yahoo.com/SIG=12bhh4h5f/**http%3A/www.soa.org/files/pdf/research-key-finding-process-planning.pdf), "The Process of Planning and Personal Risk Management." And this finding, the SOA said, highlights the need for individuals to better understand and manage inflation and longevity risks when planning for retirement.

"Individuals always need to take inflation into consideration and now is the time to take action to address these inflation and longevity concerns by planning for multiple scenarios," Steve Vernon, president of Rest-of-Life Communications and author of "Live Long & Prosper! Invest in Your Happiness, Health and Wealth for Retirement and Beyond," said in a release.

Others had a similar reaction. "The fact that more than half of all pre-retirees and retirees are sensitive to the potential negative effects of inflation risk and interest rate changes on their lifestyle in retirement is a good thing," said Christine S. Fahlund, Ph.D., certified financial planner, vice president and senior financial planner at T. Rowe Price Investment Services, Inc. "On the other hand, we have reason to be concerned that many are not considering the impact of these potential changes to their lifestyle later in retirement."

When it comes to inflation risk, Fahlund said every retiree should, for example, understand the basic fact that if annual inflation is 3% on average, in just 10 years a retiree will need to withdraw 30% more money, or more than $13, from their nest egg to purchase the same goods and services that cost $10 today. "And much more disturbing, in 20 years that retiree will need to withdraw 80% more, or $18 to maintain today's lifestyle," she said.