Retirement Income, Part 7
By Gary Case

In my last column, I discussed "longevity risk", the risk of underestimating one's life expectancy when establishing and maintaining a lifetime retirement income. This column will focus on inflation risk and how this risk impacts your retirement income planning.

The two ways inflation impacts your retirement income are; 1) by increasing the future costs of good and services and, 2) by potentially eroding the value of assets set aside to meet those costs.

During the late 1990s through the turn of the 21st century, Americans have experienced what felt like a period of relatively low inflation. But like the asset bubble of the 1990s itself, recent experience is more likely to be an exception than a reliable indicator of the future. In fact, even in the 1990s, a decade in which inflation was relatively low by recent standards, overall costs, as measured by the consumer price index, rose more than 30%. Looking over the 20th century as a whole, inflation eroded ordinary Americans' purchasing power by about 95%--reducing the 1900-dollar to less than a 2004-nickel. *

Inflation, in other words, is more the norm than the exception. The high likelihood of continued inflation makes investments that have the potential to beat inflation imperative—especially over the longer retirements that today's retirees can anticipate.

Future value calculations demonstrate the enormous impact of inflation on a retiree's purchasing power. Even at a low inflation rate of 3%, over a 25-year period, a retiree would need twice as many dollars to meet expenses at the end of the period than at the beginning!

What's more, general inflation may not capture the impact on a retiree's rising costs, especially medical expenses. Between 1994 and 1999, for example, a study by Families USA found that "prices for the 50 drugs most commonly prescribed for older Americans rose 25.2%…nearly twice the 12.8% overall inflation rate for the same 5-year period." Numerous studies also show the majority of lifetime medical costs are incurred in the last few years of life, posing additional high costs in the very last stage of retirement.

This factor should influence the end-value target of your retirement income portfolio. Aiming for an ending value of, say, $250,000 might very well provide for the expenses incurred during the last years of one's life. Next topic—Asset Allocation Risk.

*Triumph of the Optimists: 101 Years of Global Investment Return, Eric Dimson, Paul March and Mike Staunton, Princeton University Press, 2002.

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