How to Factor Inflation Into Your Retirement Planning

The annual inflation rate in the U.S. hit 7% in the final month of 2021, a record-setting high not seen since June of 1982, as reported by Trading Economics[1]. While this has led to increased prices at almost every store and at the gas pump, a more pressing long-term concern has emerged for many Americans; how will this impact them during retirement?

Here's what investors should know about inflation, how it may impact your retirement planning and — maybe most importantly — what steps you can take to safeguard your financial health.

Understanding the effect of inflation

It's important to remember that even moderate inflation can have a significant impact on your savings. The Federal Reserve's target inflation rate is 2%, but the Federal Open Market Committee (FOMC) has said it will allow inflation to rise above that mark "for some time[2]."

With this in mind, let's consider a hypothetical example provided by Kiplinger if the average annual inflation rate were to remain at 3% for the next 20 years[3]. If you needed $60,000 for your first year of retirement, in 20 years you would require $108,366.67 to match today's purchasing power of $60,000. Translation? At an annual inflation rate of 3%, the $60,000 you started out with would be worth only about $33,220 in 20 years.

As the cost of everyday items, travel and health care expenses continue to rise, inflation will only continue to eat away at the value of your savings account. Fortunately, there are several investment strategies Americans can leverage to protect themselves against inflation.

What can you do?

Although we can't control inflation, there are several ways Americans can minimize its impact on their retirement even as it continues to rise.

Map your sources of income

Your budget will look different in retirement than it did compared to while you were working. Although you'll likely have a smaller *or* entirely paid-off mortgage, you will need to consider the rising cost of health care. Knowing this, it's important to consider how your sources of income will respond either directly or indirectly to inflation.

[1] https://tradingeconomics.com/united-states/inflation-cpi
[2] https://www.federalreserve.gov/faqs/economy_14400.htm
[3] https://www.kiplinger.com/retirement/603547/how-big-of-a-threat-does-inflation-pose-to-your-retirement~:text=You%20need%20to%20factor%20inflation,do%20so%20after%20you%20retire.

Not every source of income will be negatively impacted by inflation. Once elected, Social Security benefits increase with the Consumer Price Index (CPI). Additionally, dividends from stocks in high-dividend portfolios can grow over time at rates that compare favorably with long-term inflation.

Interest payments from select fixed-income securities can provide you with a fixed rate of return. However, annuity payments from any lifetime income annuities are still vulnerable to inflation.

Another important consideration is that any withdrawals from a rollover IRA account are variable and must keep in line with Required Minimum Distributions (RMD) rules. However, these withdrawals can help you to make up any inflation deficit. By creating a balanced portfolio, you can still see returns that offset inflation.

Plan for your risks

As you look ahead to your long-term retirement plan, it's important to keep three major areas of risk in mind:

- **Longevity risk:** To reduce your chances of running out of savings, plan around sources such as Social Security, pension income and annuity payments that provide guaranteed income for life.

- **Market risk:** Aim to keep a large percentage of your income separate from changes in market returns that could leave you without a safety net.

- **Inflation risk:** Although a portion of your income should be for your lifetime and not based on market returns, you may consider building in an explicit margin for inflation risk.

Although there's no one right answer when it comes to retirement planning, the best strategy is to reevaluate your investments every few years to adjust for changes in inflation and your own personal life.

Evaluating your retirement plan

The first step to successful retirement planning is picking a long-term assumed inflation rate and managing changes in inflation in real-time. As you work to take that first step, you may want to consider working with a qualified financial advisor to discuss which options may be right for your individual circumstances.

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