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The Impact of Inflation on Retirement Plan Investing

John Italiano CFA®
Investment Analyst, Cammack Retirement Group

We have all heard the stories from our parents and grandparents about what a gallon of gas or a ticket to a movie used to cost. The cost of textbooks for a college semester in 2018 would equate to a healthy down payment on a home in 1950. Over time, there is a persistent and gradual increase in the cost of goods and services. The primary reason we save and invest our hard-earned dollars, rather than enjoy the immediate gratification of what they can buy, is the hope that the purchasing power of those dollars will increase over time. A key obstacle in the way of this is inflation - the general increase in prices and the reduction in purchasing power over time.

The current economic recovery has seen an extended period of low interest rates and economic stimulus, yet inflation has been relatively low as well. This is due in part to factors such as the new money from Fed stimulus not entering the economy, a slow global economic recovery, and depressed energy prices. The month of January saw a sharp 0.5 percent jump in inflation, excluding food and energy prices. However, the reading for the month of February was a tamer 0.2 percent (1.8 percent annualized). While inflation is still low, there are concerns that it could accelerate. In addition to the long-term impact inflation has on the purchasing power of money, it can also affect the investments of retirement plan participants in the short term. The impact is different across each asset class and sector of the market.

INFLATION AND STOCKS

Unexpected and sharp increases in inflation can be a drag on stock returns, as companies attempt to combat higher input costs by passing them on to consumers. On the other hand, periods of normalized inflation (i.e., 2-3% annual inflation rate) can lend itself to strong stock returns. Environments where inflation pushes higher than 3% tend to coincide with volatile equity markets, as investors try to understand the macroeconomic issues at play. Stocks are typically categorized as either value or growth. Value stocks have strong current cash flows that tend to slow as time passes. Growth stocks have little or no current cash flow, but cash flows will gradually increase over time. Rising inflation tends to have a stronger negative impact on growth stocks than value stocks. Interest rates are often raised to combat inflation, and this causes the present value of future cash flows to be discounted at a higher rate (and thus reduces their present value). The cash flows of growth stocks are anticipated to be higher in the future. In periods of inflation, investors may discount growth stocks at a higher rate, making them less attractive and hurting their valuations. Relative to their growth counterparts, value stocks have fared better in inflationary environments due to their cash flows being more immediate.

THE IMPACT ON FIXED INCOME

When considering cash flow, it is also important to understand how inflation impacts the fixed income market. A traditional bond is an instrument that gives the holder a stream of cash flow (coupons) over a period of time. When inflation increases, interest rates tend to rise as well. This negatively impacts the present value of those future cash flows. Simply put, if rates rise across the credit curve, investors may begin to demand higher rates of return or lower prices for bonds being traded. Additionally, if inflation is on the rise, the future coupon payment of a bond will buy less goods and services than it would today.

Fixed income instruments have a wide range of maturities, and inflation impacts these bonds differently. As inflation and rates rise, short-term bonds (i.e., those with a maturity of three years or less) tend to offer better protection than bonds with more distant maturities. Holders of short-term bonds receive their coupons sooner and are able to reinvest quickly at potentially higher rates of interest. The credit quality of a bond is also a key consideration. Performance varies when comparing U.S. Treasury securities, with higher credit ratings, to corporate bonds, with lower credit ratings. If the economy is perceived to be healthy during an inflationary period, markets will favor bonds with lower credit ratings since they come with a higher coupon rate than U.S. Treasuries. On the other hand, if the market feels the economy is not on good footing, markets will favor bonds with a higher credit rating, such as U.S. Treasuries.

Exhibit 3. Annualized Return by Fixed Income Asset Class

Rising Rate Periods			
Period I November 1986 to March 1989	**Period II** January 1994 to April 1995	**Period III** February 1999 to July 2000	**Period IV** June 2004 to August 2006
Stable Value **8.58%**	Stable Value **6.27%**	Stable Value **6.31%**	High Yield **8.81%**
High Yield **7.42%**	High Yield **5.60%**	TIPS **5.91%**	TIPS **4.85%**
Cash Equivalent **6.92%**	Cash Equivalent **4.65%**	Cash Equivalent **5.28%**	Securitized Assets **4.49%**
Short-Term Credit **6.85%**	Short-Term Credit **4.27%**	Short-Term Credit **4.64%**	Stable Value **4.47%**
Corporates **6.35%**	Short-Term Treasuries **3.63%**	Short-Term Government/Credit **4.25%**	Corporates **4.24%**
Short-Term Government/Credit **5.89%**	Short-Term Government/Credit **3.63%**	Short-Term Treasuries **4.22%**	Aggregate Bonds **4.17%**
Short-Term Treasuries **5.82%**	Corporates **2.59%**	Securitized Assets **3.62%**	Treasuries **3.72%**
Aggregate Bonds **5.62%**	Aggregate Bonds **2.54%**	Aggregate Bonds **2.21%**	Cash Equivalent **3.14%**
Treasuries **4.69%**	Treasuries **1.84%**	Treasuries **2.08%**	Short-Term Credit **2.86%**
Securitized Assets **N/A**	Securitized Assets **N/A**	Corporates **0.60%**	Short-Term Government/Credit **2.54%**
TIPS **N/A**	TIPS **N/A**	High Yield **0.29%**	Short-Term Treasuries **2.29%**

Data Source: Barclays Risk Analytics and Index Solutions ltd (BRAIS); BofA Merrill Lynch Global Index System; Hueler Companies, Inc.

High-yield bonds offer higher coupons and yields relative to investment-grade bonds. Investors accept the increased credit risk of high yield bonds in exchange for a higher yield. The value of high-yield bonds is impacted by many economic factors in addition to interest rates and inflation. Their higher coupon rates cushion the bondholder by offsetting some of the effects of rising rates. This has been the case in environments where rates rise slowly and the economy is sound. However, it is important to understand that high yield bonds carry credit risk, and their values are highly correlated with stock values, making them more volatile than investment-grade bonds in times of economic turmoil.

Treasury Inflation Protected Securities, better known as TIPS, are instruments that adjust their par value based on the rate of inflation, as measured by the Consumer Price Index (CPI). As inflation rises, so does the par value of the security. TIPS bonds carry extremely low credit risk as they are issued and backed by the U.S. Government. However, they do carry almost direct exposure to inflation risk. If inflation slows, the par value of the bond will be reduced. Please reference the following example:

Suppose an investor owns $1,000 in TIPS at the end of the year, with a coupon rate of 1%. If there is no inflation as measured by the CPI, the investor will receive $10 over the year in coupon payments. If inflation rises by 2%, however, the $1,000 principal will be adjusted upward by 2% to $1,020. The coupon rate will still be the same at 1% but it will be multiplied by the new principal amount of $1,020 to get an interest payment of $10.20. On the other hand, if inflation was negative, as in deflation, with prices as measured by the CPI falling 5%, the principal would be adjusted downward to $950. The resulting interest payment would be $9.50 over the year.[1]

Floating-rate bonds are another option to combat inflation and rising rates since their coupon increases in conjunction with the U.S. Treasury Bill rate, LIBOR, or the Federal Funds rate. These instruments usually carry a maturity in the two to five year range, and are issued by institutions and governments. Rising rates that often accompany inflation would cause floating-rate bonds to outperform most other fixed-income instruments. However, it is important to note that these bonds do carry credit risk, and periods of economic turmoil may cause them to lose value, perhaps sharply. Retirement plan participants typically are typically exposed to these instruments in small allocations within bond mutual funds that encompass many sectors of the fixed-income universe.

CONCLUSION

Inflation is one of many economic factors that impacts the value and performance of retirement savings. Equities tend to withstand an inflationary period better than most sectors of the bond market. The timing and consistency of cash flows from equity and bond investments are key considerations in determining how sensitive an investment is to inflation and rising rates. Investments that produce cash flows that are more distant (long-term bonds or growth stocks) tend to lag in an inflationary environment. On the other hand, value stocks, high yield bonds, TIPS, and floating-rate bonds can offer some protection to investors when inflation is on the rise.

Offering a diverse array of investment options to retirement plan participants can allow them the flexibility to protect their portfolio when rates rise. Certain actively managed mutual funds can make tactical allocations to asset classes that have performed better in inflationary conditions. It is important to note that economic conditions aside from inflation and interest rates can impact the performance of securities that may have weathered inflation in the past. While outcomes can never be guaranteed, diversification is paramount to realizing the best possible retirement plan outcomes over the long-term.

[1]*Investopedia*

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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