A Primer on Inflation

Investors risk outliving financial resources and eroding purchasing power without careful planning for the impact of inflation.

THE BASICS: Inflation is defined as a sustained increase in the general level of prices for goods and services. Inflation *erodes purchasing power* and each dollar buys a smaller amount of goods and services.*

INFLATION RISKS: Inflation decreases the amount you're able to purchase over time and erodes real savings and investment returns. Most investors aim to increase their long-term purchasing power. Inflation puts this goal at risk because investment returns must first keep up with the rate of inflation before increasing real purchasing power. For example, a 2% return on an investment *before inflation* in a 3% inflation environment will actually produce a negative inflation-adjusted return (-1%).

RETIREMENT PAYMENTS: Inflation can be harmful to fixed-income returns in particular. Many investors buy fixed-income securities for stable income streams in the form of interest, or coupon, payments. However, because the rate of interest (or coupon) on most fixed-income securities remains fixed until maturity, the purchasing power of the interest payments declines as inflation rises. Assuming an investor purchased $1 million in fixed income with 6% annual coupon payments, over a ten year period the real value of those payments—adjusted for inflation—falls.

Year	Annual Fixed Income Payments	Annual Loss of Purchasing Power (Inflation)	Cumulative Loss of Purchasing Power Due to Inflation (In Today's Dollar Terms)	Annual Income Necessary to Keep Up with Inflation
Year 1	$60,000	3.07%	$1,844	$61,844
Year 2			$3,745	$63,745
Year 3			$5,704	$65,704
Year 4			$7,723	$67,723
Year 5			$9,804	$69,804
Year 6			$11,950	$71,950
Year 7			$14,161	$74,161
Year 8			$16,440	$76,440
Year 9			$18,789	$78,789
Year 10			$21,211	$81,211

Source: Global Financial Data, Inc. as of 3/9/2012. The average Consumer Price Index (CPI) was 3.07% for 12/31/1925 - 12/31/2011.

*Source: www.investopedia.com

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March 2012 M06052

A Primer on Inflation (continued)

PRINCIPAL VALUE: In much the same way, rising inflation erodes the principal value of fixed-income securities. If an investor buys 10-year bonds with principal values of $1,000,000 and the rate of inflation is 3.07% annually, the value of the principal *adjusted for inflation* will sink to about $731,800 over the 10-year term of the bond. That means when an investor "gets their million dollars back," it won't buy $1million worth of goods and services in inflation-adjusted terms.

Year	Principal Value (Adjusted for Inflation)	Annual Loss of Purchasing Power (Inflation)	Loss of Purchasing Power to Inflation Each Year	Inflation-Adjusted Future Value
Year 1	$1,000,000	3.07%	$30,733	$969,267
Year 2	$969,267		$29,788	$939,479
Year 3	$939,479		$28,873	$910,606
Year 4	$910,606		$27,986	$882,620
Year 5	$882,620		$27,126	$855,494
Year 6	$855,494		$26,292	$829,202
Year 7	$829,202		$25,484	$803,719
Year 8	$803,719		$24,701	$779,018
Year 9	$779,018		$23,942	$755,076
Year 10	$755,076		$23,206	$731,871

Source: Global Financial Data, Inc. as of 3/9/2012. The average Consumer Price Index (CPI) was 3.07% for 12/31/1925 - 12/31/2011.

SAFETY: Investors in or near retirement usually assume a "safe" course is to invest their assets so they have access to the money at any time; savings accounts, checking accounts, and certificates of deposit (CDs). These investors likely believe they are making good decisions when pursuing this approach. But there's a tradeoff for security and ready availability: their money can earn a low rate of return and may be more susceptible to inflation pressure and loss of purchasing power.

LONGEVITY: Retirees generally live several years—sometimes *decades*—beyond retirement. Fixed monthly income will decrease in purchasing power with each year because of inflation: you'll likely need to rely on other investments as time goes forward.

Without careful planning for inflation's impact, investors risk outliving financial resources and eroding purchasing power—before and after retirement.

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