Inflation: The silent killer

By Rocco Carr, Business Development Manager at Glacier by Sanlam

To understand inflation, one needs to understand the implication of what, for example, 4% inflation actually means, and the effect it has on your spending power. Many people refer to the current inflation rate without understanding the implication it has in real life.

What is inflation?

Inflation is the rate at which prices increase on a basket of goods, or on a specific product or service. Therefore, if it is announced that the current inflation rate is 4%, it refers to the rate at which a basket of goods in South Africa has increased in price over the past 12 months (if it is measured year-on-year). Sometimes the rate is also shown as the rate for a specific quarter, or half year. One therefore needs to make sure, when quoting an inflation rate, of the term for which it is applicable.

So, if an item cost R100 one year ago, and the inflation rate was 4% for the past year on that specific item, it means that the current price of that article will now be R104. Another factor one needs to understand as far as inflation is concerned, is the compounding effect it has. If the inflation rate is again 4% in the next year, the price will not go up with R4 as in the first year, but it will go up by 4% of R104. The new price at the end of year two will now be R108-16. Most people understand the benefit of compounded growth over time but fail to understand the destruction of compounded inflation over time.

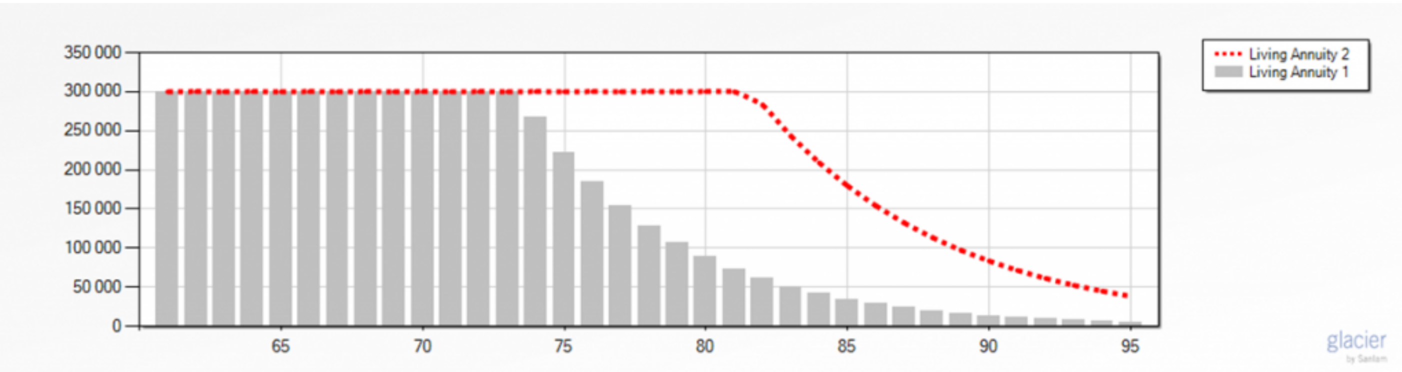
Rule of 72

A simple method of calculating the impact of an inflation rate over time, is by using what is referred to as the Rule of 72. This means that if you divide 72 by the expected inflation rate over time - let's assume 6% - the answer will give you an indication of the half life of your investment's purchasing power. In this example, the answer is 12 (72 divided by 6), so your purchasing power, if you have no growth, will halve over 12 years. Therefore, after 12 years, your R100 will only buy R50 worth of goods and services, and after another 12 years, only R25. It is therefore imperative that your portfolio has a return in excess of inflation.

Retirees and inflation

So, where does this leave people who are retiring? While you are still in the wealth accumulation phase, your portfolio should be structured in such a way to allow growth assets, which can outperform inflation consistently over time, to build up wealth. However, many clients reaching retirement are so scared of volatility, that they elect to rather stay in low-yielding instruments. This choice often destroys purchasing power eventually, and although inflation is often not a tangible thing, people slowly but surely get drawn into a situation where they struggle to make ends meet.

In order to fight the effects of inflation, retirees should attempt to take on more growth assets in a portfolio, which can give a return of, for example, inflation plus 5% (in a moderate aggressive portfolio) rather than the inflation plus 2% of a conservative portfolio. The following comparison shows the projected period of a client's income in two portfolios: one conservative and the other a moderate aggressive portfolio, respectively. In this case, the client is 61 years old, takes an income of 6% and requires the income to escalate with inflation (assumed at 5%) each year.



In the conservative portfolio (grey bars) the client initially keeps pace with inflation, but after the age of 73 their income withdrawal rate reaches the limit of 17.5%, and they will start to feel the effects of limited purchasing power. However, the riskier portfolio (red line) extends this inflection point up to the age of 82. One of the biggest fears when taking on a higher risk, is the impact of sequence risk during volatile periods. Sequence risk is simply the risk of a market downturn in the years leading up to, or just after, the point of retirement. We've experienced this over the past five years and we've subsequently seen clients preferring to take on less risk, often to their own long-term detriment.

The Glacier Invest 5% Real Income Solution Wrap Fund aims to reduce the risk to that of a cautious (inflation plus 2%) portfolio, while taking on growth assets in line with a moderate aggressive portfolio to achieve a return of inflation plus 5%. With this portfolio, which includes hedge funds and a smooth growth portfolio*, a cautious investor can fight the impact of inflation without experiencing the associated risk.

* The smooth bonus portfolio is a pooled investment solution made available by Sanlam Life.

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