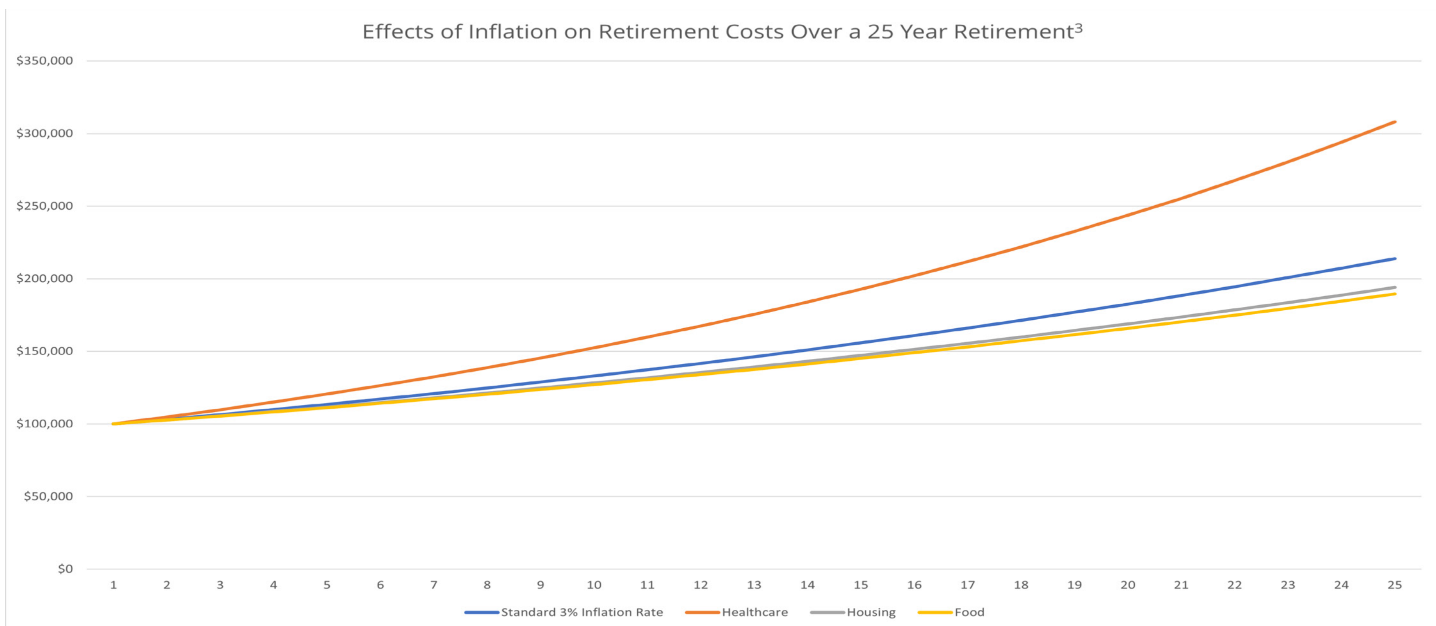
Inflation in Retirement

As clients prepare for and enter retirement, several factors need to be evaluated to ensure a successful and sustainable retirement lifestyle. One of the factors that must be considered is the long-term effect of inflation. Many clients rely on a fixed income that does not increase over time, potentially leaving a client at risk of having to modify their lifestyle in their later years to avoid running out of money. There are numerous ways to approach this risk. A combination of multiple retirement income streams that includes a fixed index annuity (FIA) with an increasing income rider may be one option to create the lifestyle your clients have planned and saved for. Income benefit riders may be offered either built-in or for an additional cost.

UNDERSTANDING INFLATION RISK

Inflation is, simply put, the rising cost of goods and services over time. These increasing costs decrease the purchasing power of money as inflation rates increase. We see the effect of inflation over time in almost every aspect of daily life. The average inflation rate over the past thirty years is 3.22%[1] and usually rounded down to 3% for ease. To apply this effect to a real-life scenario, think of a simple candy bar. If we use the 3% rate, a candy bar that cost $0.50 in 1990 would cost $0.95 today, an increase of 90%. However, if you were to go to a convenience store today, you would see a standard candy bar retail price is $0.99, an increase of 98%. This means that the price of candy increased by 3.27% each year, slightly faster than the national inflation rate. On a small scale, that seems manageable but think about this effect on a grander scale with a specialized service critical to retirees: healthcare.

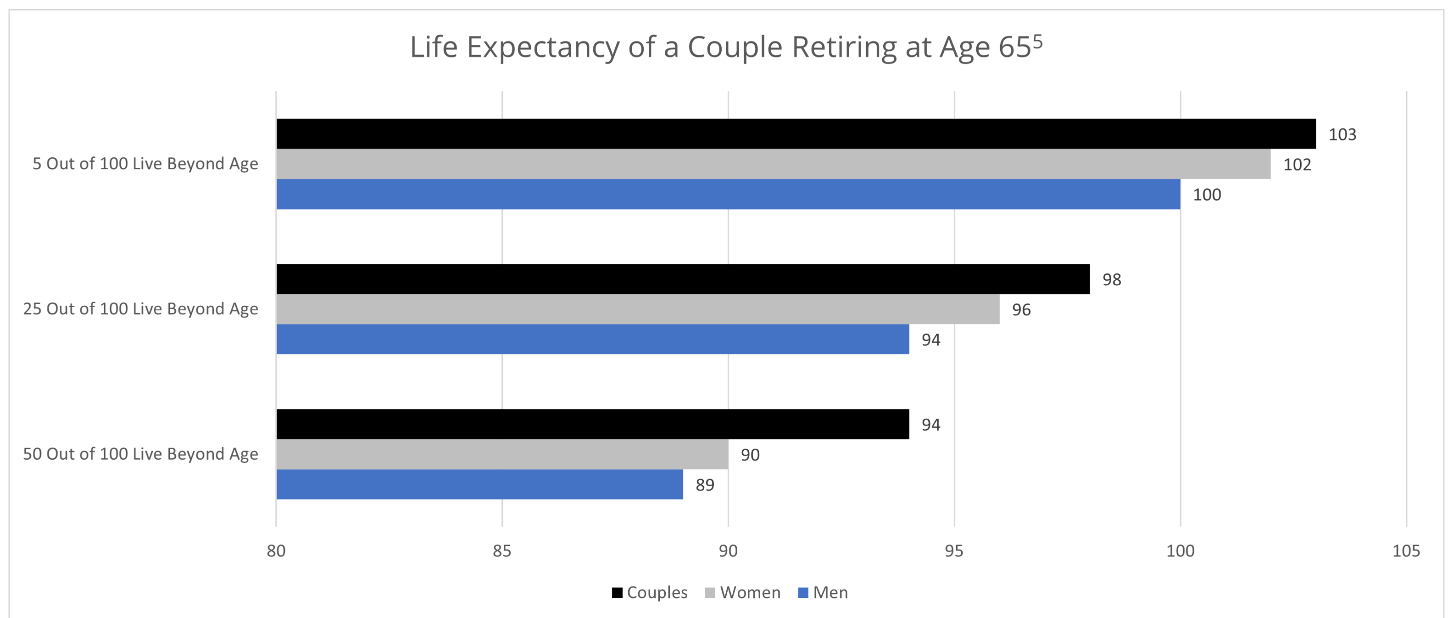
According to an analysis of the Bureau of Labor Statistics Consumer Expenditures Survey by data company Clever, in 1984, the average American household spent $2,500 on healthcare. In 2018, that average had risen to $5,000, an increase of 100%. Even more alarming, the study also found that medical insurance premiums have increased by 740% since 1984.[2] These increases over time can quickly eat away at a fixed income and deplete a nest egg if not prepared for in advance.



BUT WAIT, THERE'S MORE

Inflation is not alone in the risk to retirement savings; it partners with longevity risk to create a scenario that clients must prepare for. Longevity risk is the risk that someone will outlive their retirement savings. Consider this; if Client A retires in 2020 at age 65, but passes away in 2022, it is likely safe to assume that the inflation rate over those two years did not have much of an effect on Client A's lifestyle. In hindsight, it would not have been something that Client A needed to prepare for.

However, a scenario like the previous one is far more often the exception and not the norm. In fact, what statistics show is that life expectancy has increased over time due to medical advances in curing or treating diseases and conditions therefore prolonging human life past what was once considered terminal. In 1955, when those turning age 65 in 2020 were born, the average US life expectancy was 69 years old. In 2020, that average has increased by 10 years to 79. According to the IAM Basic Mortality Table[4], a 65-year-old couple retiring in 2020 has a 50% chance that one will live to age 94. Longer life expectancies mean that a client's longevity risk goes up, which signals that retirement savings should also increase in preparation for a longer retirement.



When longevity risk and inflation risk are not properly accounted for, clients may be potentially leaving themselves unable to sustain the lifestyle they planned for during retirement.

WAYS TO APPROACH THE PROBLEM

For financial professionals, if you do not help your clients hedge against the risk of inflation, you may be leaving yourself and your practice at risk for an eventual "Assets Under Management (AUM) timebomb" as clients need to access their investments to supplement income. As the Prudential Global Investment Management (PGIM) 2020 Capital Market Outlook predicts, conservative investments may be facing an environment of low-interest rates for the foreseeable future.[6] From 1980 to 2018, the Barclays US Aggregate Bond Index returned an average of 7.67%.[7] However, the Q2 2020 Capital Market Assumptions from PGIM is predicting US Aggregate Bonds will experience a return of only 1.84% over the next 10 years,[8] which may not be enough for clients to keep pace with expenses if they are expecting returns similar to the prior 40 years. The fact that previous investment strategies may not keep pace with the needs of inflation is becoming more and more of a possibility. Decreasing AUM poses a significant risk to a practice's value and the income of a financial professional who relies on AUM and management fees.

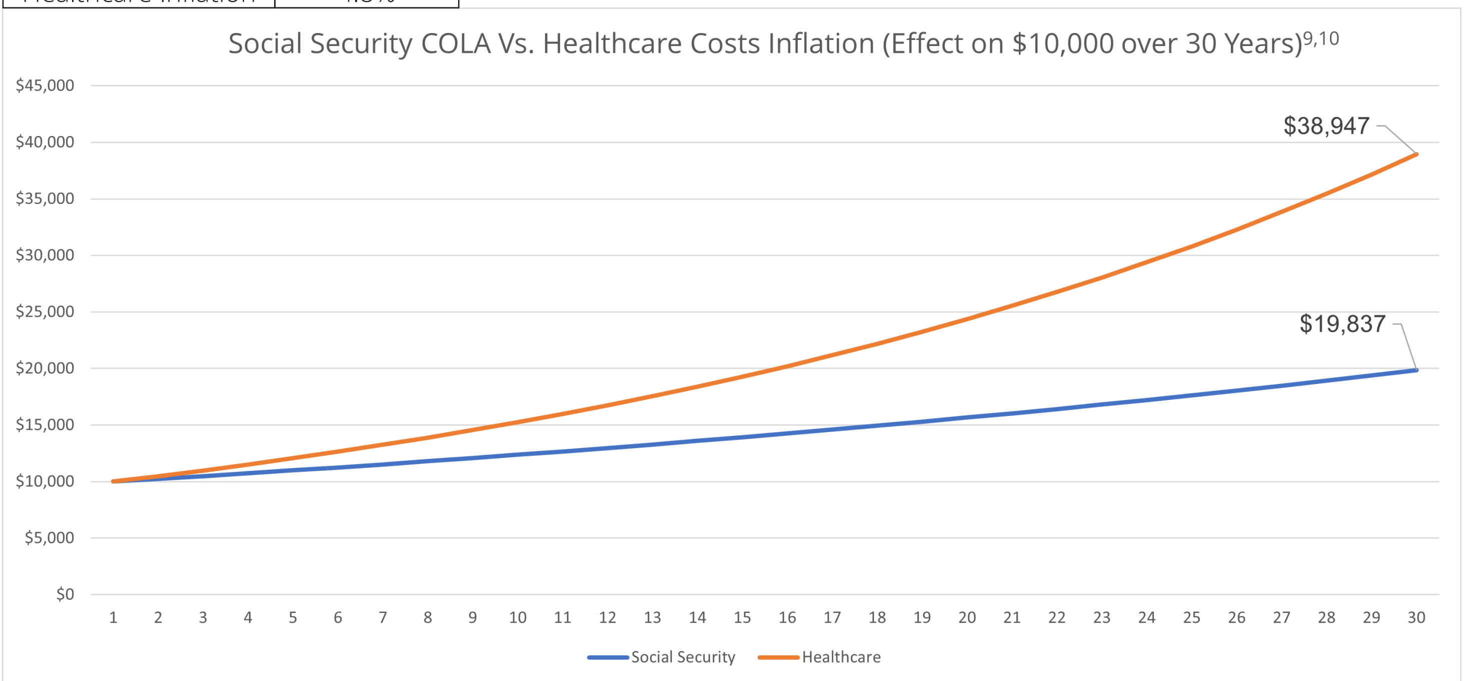
When working with clients to prepare for retirement, financial professionals often use three common approaches to help clients address these risks. One approach is to use Social Security Cost of Living Adjustments (COLA) to bridge the gap. Another is to use Social Security alongside an investment strategy of stocks and bonds to supplement retirement income. The final approach we will look at is using both of those partnered with an FIA with an increasing income rider to supplement retirement income.

USING SOCIAL SECURITY COST OF LIVING ADJUSTMENT ALONE TO SUPPLEMENT INCOME

Social Security is a prevalent way of providing retirement income. After all, clients have been paying into Social Security from each paycheck during their working years and will benefit from those years of payments in the form of a dependable lifetime income stream. However, relying solely on COLAs to keep pace with inflation can become problematic throughout retirement.

Over the past 30 years, the average COLA increase has been 2.39%. However, when considering that one of the major costs to retirees is healthcare, which has averaged a 4.8% increase in out-of-pocket expenses over the same period, the problem becomes crystal clear. A 2.41% yearly gap over a thirty-year retirement is very difficult to overcome and may lead to a lifestyle change that your client may not have planned for.

Historical Inflation Rates (1990-2019)	
Social Security COLA	2.39%
Healthcare Inflation	4.8%



SUPPLEMENTING WITH A STOCK AND BOND INVESTMENT STRATEGY

Many will find that this approach, combining Social Security COLAs with an investment portfolio, is a workable solution. Although this strategy does not come without some risk. Take the market correction of 2008. The S&P 500 index was down 37%, while the Social Security COLA was 0.0% and would be for the following year as well. For clients who needed income from their investment portfolio to maintain their lifestyle, many would be forced to sell their stocks and bonds at a significant loss and deplete their retirement savings faster than intended.

The effects of having to sell investments during a down market can significantly decrease the longevity expected for those funds and create a challenging situation for a client long-term. For clients that want greater control and greater stability, they may want to look at the final solution, a three-pronged approach using Social Security COLA, an investment portfolio, and supplement those with an FIA equipped with an increasing income rider.*

USING AN FIA WITH AN INCREASING INCOME BENEFIT

To understand how an FIA with an increasing income rider helps supplement a retirement income strategy, a client must first understand how an increasing income rider differs from other types of income riders.

Today, most income riders provide a guaranteed amount of lifetime income.** That level of income does not change. As a result, if the annuity generates $10,000 per year, that amount will remain unchanged for the client's life. Or to look at it through the eyes of inflation, assuming a 3% inflation rate, after 24 years the purchasing power of the $10,000 will have been cut in half.

Alternatively, an FIA that features an opportunity for increasing income generally provides for increases based on the performance of an underlying index or the CPI. For example, if the index (subject to the FIA's caps, par rates, or spreads) were to increase by 4%, the income generated by the income rider would increase by 4%. Today, many carriers offer product designs that offer the potential for increasing income. These features take many shapes so care must be given to fully understand the specifics of a particular product. They also may be offered either built-in or for an additional cost.

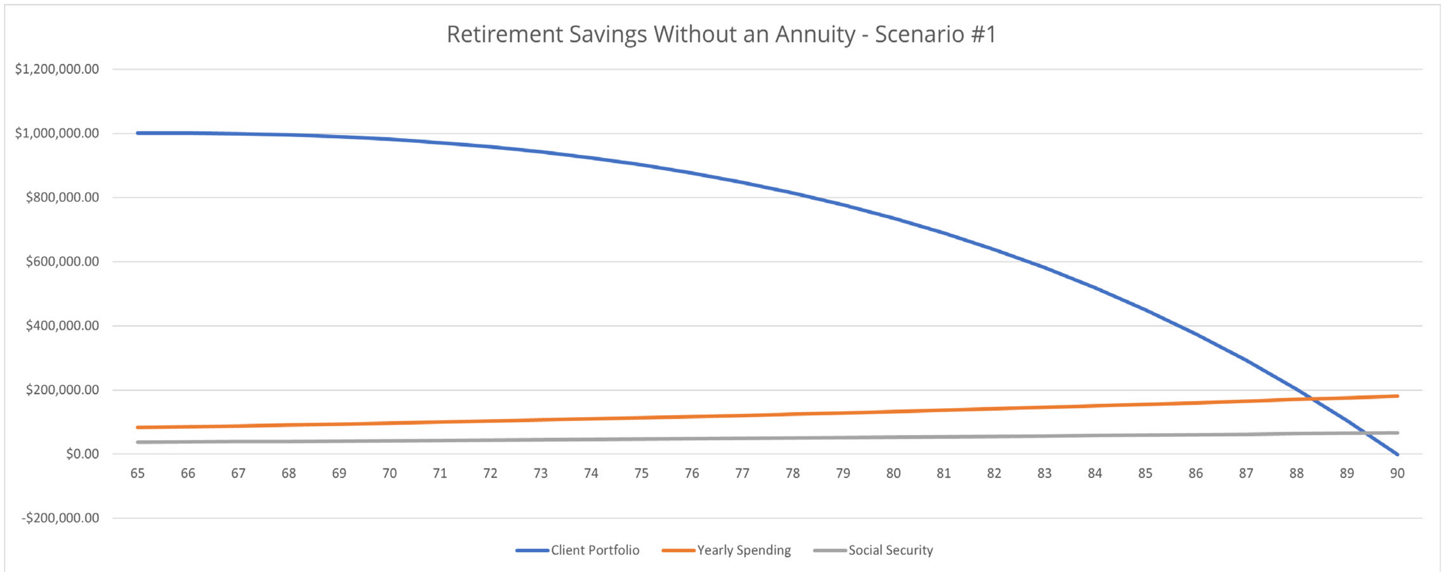
To better illustrate the impact an increasing income benefit can have on a client's portfolio, consider the graphs below that illustrate two scenarios, one using portfolio returns to supplement income and the other using both a portfolio and FIA with an increasing income rider to supplement income. When looking at the two and comparing them to one another, the impact an increasing income benefit can have on a client's overall retirement income plan is drastic.

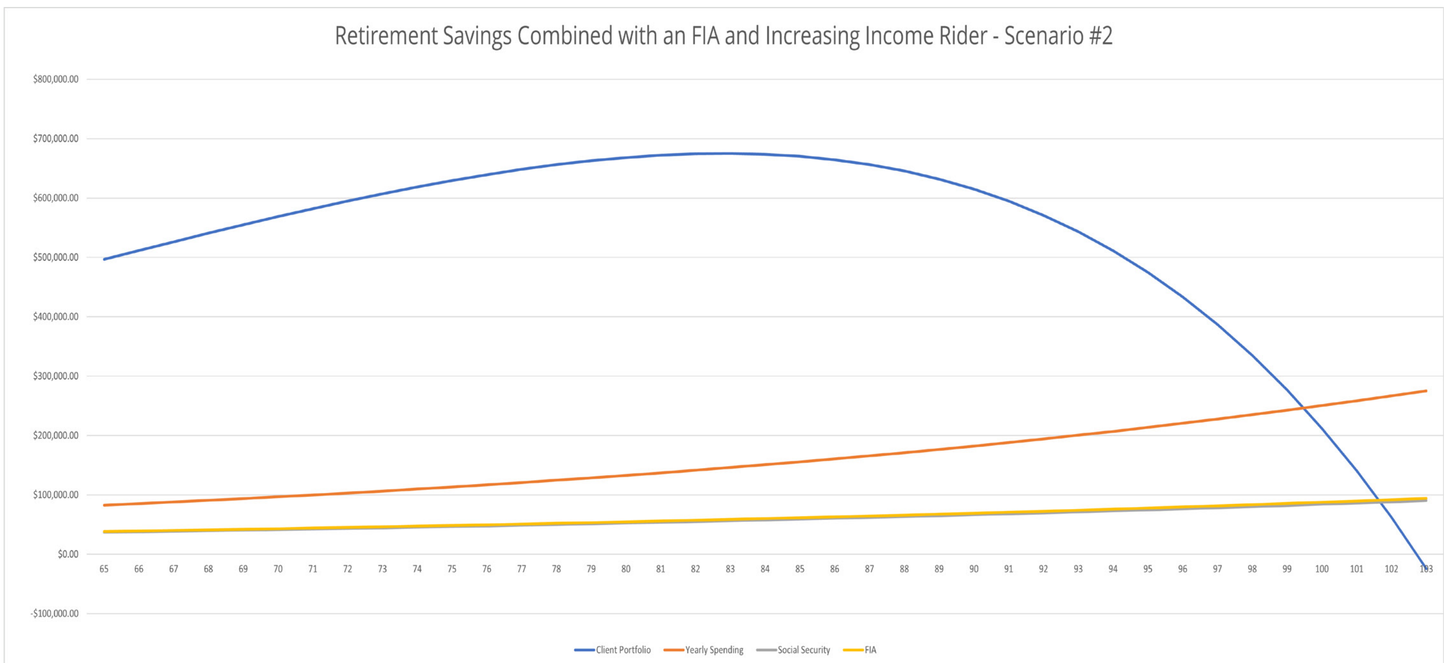
For both scenarios, the following assumptions are used:

SCENARIO #1	
Retirement Savings Portfolio	$1,000,000
Average Return on Portfolio	4.84%
Average Yearly Spending Year 1 of Retirement	$75,000
Expense Inflation Rate	3.22%
Social Security Payout Year 1 of Retirement	$45,000
Social Security COLA	2.39%

SCENARIO #2	
Retirement Savings Portfolio	$500,000
FIA with Increasing Income Rider Initial Premium	$500,000
FIA Index Performance	4.00%
FIA Payout Rate	3.75%
Average Return on Portfolio	4.84%
Average Yearly Spending Year 1 Retirement	$75,000
Expense Inflation Rate	3.22%
Social Security Payout Year 1 of Retirement	$36,000
Social Security COLA	2.39%

This example is shown for illustrative purposes only, is not guaranteed, and should not be used to predict or project future results. Actual results will vary. Portfolio performance, FIA index performance, and inflation rates may all be higher or lower. Additionally, assumptions assume market and economic conditions are constand and not variable.





In Scenario 1, with our assumptions, the client's nest egg is depleted at age 89. As a result, the client has only Social Security to maintain their quality of life and cover their income needs.

However, using an FIA with an increasing income rider as Scenario 2 shows, the client's portfolio lasts significantly longer, all the way to age 103.

It should be noted that these scenarios do tend to oversimplify real-world experience. For example, the analysis does assume constant returns, COLAs, and inflation. The introduction of market volatility and the potential impact of sequence of returns risk would certainly alter these results.

WRAPPING IT UP

As clients prepare for retirement, there are many considerations and risks. Inflation rate risk is one of these considerations that should be addressed when building a retirement income strategy. When coupled with longevity risk, potential increasing inflation may quickly become a bigger and bigger risk. There are many ways to approach this rising risk. While every client situation is different, when appropriate, a three-pronged approach of Social Security, an investment portfolio, and an FIA with an increasing income rider can help provide the client with the flexibility and funding to live the retirement you helped them prepare for.

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*Income benefit riders may be offered eithr built-in or for an additional cost.
**Guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company.

(1) US Inflation Calculator; https://www.usinflationcalculator.com/inflation/historical-inflation-rates/
(2) How U.S. Health Policy Changes Have Affected Healthcare Costs Over Time; https://listwithclever.com/research/healthcare-costs-over-time/
(3) J.P. Morgan 2020 Guide to Retirement; https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-retirement
(4) 2012 IAM Basic Mortality Table (Published in 2015)
(5) See note 4
(6) Prudential PGIM 2020 Q2 Capital Market Assumptions; https://mconnect.iscorp.com/prudential/viewDocument.action?token=a209ec38796983cd3f9634b998b07577c54d6f831054c8b80b487c46012b0b28
(7) Aggregate Bond Index Returns vs. Stocks '80-'18; https://www.thebalance.com/stocks-and-bonds-calendar-year-performance-417028
(8) See note 6
(9) Social Security Administration, Cost-Of-Living Adjustments 1990-2019; https://www.ssa.gov/OACT/COLA/colaseries.html
(10) See note 3

Fixed index annuities are designed to meet long-term needs for retirement income. Early withdrawals may result in loss of principal and credited interest due to surrender charges. Withdrawals are subject to ordinary income tax and, if taken prior to 59½, a 10% federal tax penalty. Guarantees are backed by the financial strength and claims-paying ability of the issuing insurance company.

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