THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

EFFECTS OF INFLATION

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Inflation

Remember when everyday products were much cheaper than they are now? That's a real-life example of inflation, an unavoidable phenomenon that erodes the value of money by pushing prices up over time. If capital isn't being put to work and making a return during inflationary periods, the purchasing power of investor capital is declining.

Investors have a wide range of tools at their disposal to help protect their portfolios from the ravages of inflation. Some prefer inflation-protected bonds, while others swear by commodities such as gold as effective inflation hedges. Investing in stocks has historically been one of the best ways to offset, or even outpace, inflation's degenerative effects on one's savings.

We still have a tremendous amount of interest from advisors looking into commodity funds, ETFs and other inflation protection instruments to protect against potential inflation.

Common Stock

If you're worried about inflation, we believe that you should own common stocks. Nothing -- I repeat nothing – has historically performed better as an inflation hedge over the long term. And we believe this is not going to change. It's simple logic. If there is inflation, companies will raise the prices of the goods and services they sell to protect profits. And if they can't raise their prices because of competition then they will cut costs.

The bottom line is that profits will grow over time, outpacing inflation, and those profits are put back to work to expand and grow, which means new profits. Best of all, society gets the real goods and services that it needs to thrive and raise living standards, not simply some metal bars that sit in a vault.

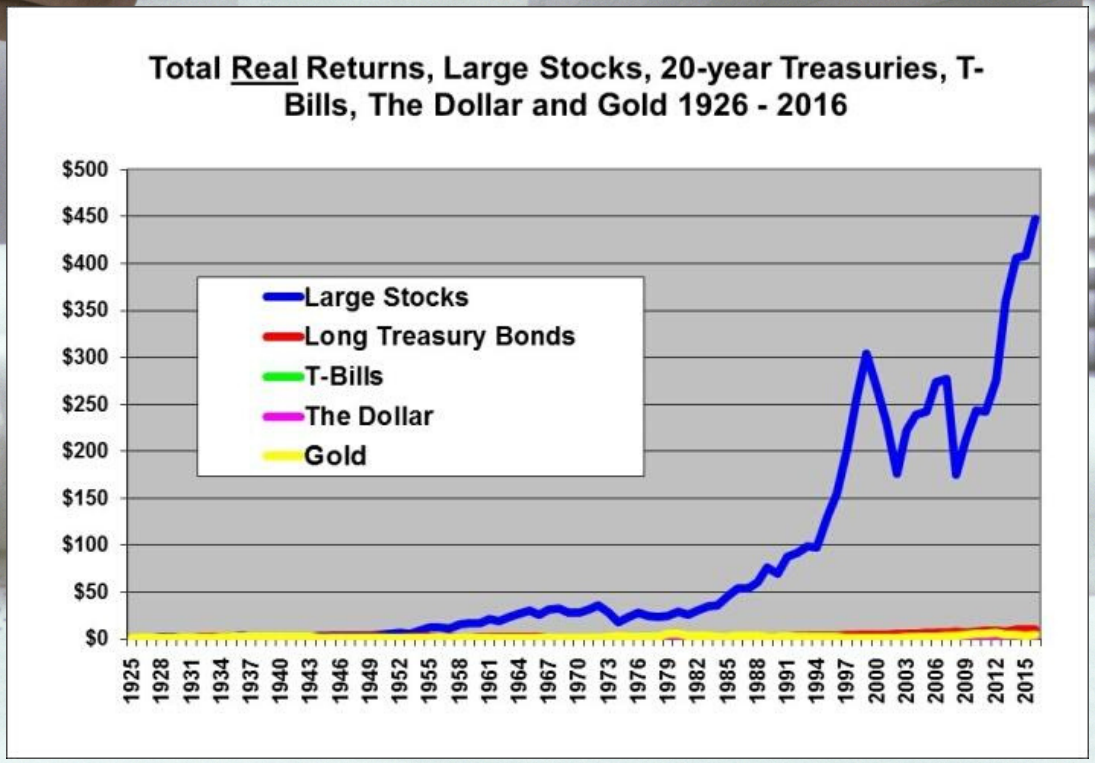
Rich Pzena's Excerpt

Below is an excerpt from a write up by Rich Pzena who states that commodities have been notoriously bad at beating inflation, and, with the exception of a handful of periods, have produced negative real returns. Stocks and particularly Value Stocks have actually performed better.

Do Commodities = Inflation Hedge?

An often ill-conceived strategy to hedge the risk of inflation is commodities.

But commodities have been notoriously bad at beating inflation, and, with the exception of a handful of periods, have produced negative real returns. Consider the following data. :Since 1960, commodities (with the exception of crude oil and perhaps a few others) have, on average, produced negative real returns measured on a ten year basis. The probability of a real loss is enormous, and the maximum losses are huge. And although oil has had positive real returns, the variability of outcomes and the probability and magnitude of potential loss makes it hard to consider commodities a low risk strategy or even a valid inflation hedge.



So why are equities so much better than commodities or bonds in protecting against inflation? It stands to reason that businesses have the ability to adapt to their environments. Thus a recession, or a period of rising prices, or the emergence of new competitive markets, are met with a response by the management teams to mitigate or even exploit these changes. This was demonstrated in the recent global financial crisis where unprecedented demand drops were met with management actions which reduced the downside to their businesses. Today margins are back to pre-crisis levels.

Commodities do a Poor Job of Hedging the Risk of Inflation

Measures of Risk and Return

Ten-Year Holding Periods (1960 - 2011)

	Commodity Type		
	Non-Energy*	Metals/Minerals	Crude Oil
Average Annual Real Return	-1.3%	-0.6%	5.2%
Standard Deviation of Ten-Year Returns	3.9%	4.6%	12.3%
Probability of Loss	65%	65%	43%
Worst Ten-Year Loss	59%	63%	74%

Source: World Bank GEM Data (http://databank.worldbank.org/ddp/home.do?Step=12&id=4&CNO=175)

*Includes agriculture, fertilizers, metals & minerals and base metals

Stocks and Inflation

Stocks are not an ideal short-term hedge against rapidly increasing inflation, but bonds are worse. Bonds are promises to pay in dollars, and those dollars are fixed unless you hold Treasury inflation-protected securities or other IOUs that adjust their payments with changes in the general level of prices. In an inflationary environment, investing in short-term bonds is better than investing in long maturities; as inflation rises, you can take advantage of rising interest rates. Gold and commodities also do well in periods of high and increasing inflation. But, like bonds, they have poor results over the long term. Gold, for example, has returned only 0.7 percentage point per year more than inflation over the past two centuries.

A strategy for insulating your stock portfolio against inflation is to diversify internationally. If inflation kicks into overdrive, the dollar will fall and foreign stocks will act as an automatic hedge as money invested in foreign currencies is translated into more dollars back home. But don't run to speculative assets that will deflate in price when inflation slows. For long-term investors, stocks may be an excellent hedge against rising prices.

Lazard Asset Management

Lazard Asset Management, in a white paper, agrees that stocks over the long term provide adequate hedging of inflation. The research paper highlights how the past two to three decades of unusually low and stable inflation is soon coming to an end due to high debt in both the "public and private sectors in many OECD countries, extremely expansive monetary policies, and rising commodity prices as a result of booming demand from emerging markets"6. So in order protect your assets from depreciating, Lazard Asset Management recommends diversifying in stocks because of past empirical data and the highly, liquid and transparent nature of stocks.

However, the (short-term) inflation protection is limited because the correlation between real stock returns and inflation in the same year is negative. As inflation rises, real stock returns decline, but only become negative in an environment of extremely high inflation. But over long return horizons (of five or more years), stocks have historically offered inflation protection. Lazard Asset Management found that "given an investment horizon of five years or more, stock returns…exceed the inflation regardless of the inflation regime"6. This is because stock returns, with some degree of certainty, exceed the inflation rate due in part to the high long-term equity risk premium.

Dividend Yield and Inflation

Stocks provide a good hedge against inflation, providing a tangible return and cash flow to the shareholder. By selecting individual stocks with higher dividend yields - but that are still stable companies - it is also possible to significantly outpace inflation. Since dividend yields and inflation are in constant flux, it is sometimes necessary to exchange one stock (or several) for another in order to continue outpacing inflation. In certain years, inflation may win, but over the long-term, by consistently picking high quality dividend stocks, it is possible to generate a higher yield than inflation.

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Pension and Inflation

Rising interest rates also play a large role in the decision of whether to take your pension as an annuity or a one-time lump sum payment. As inflation continues to rise, the Fed has responded by gradually increasing interest rates, which decreases the value of the future pension payments as well as the lump sum value. This is because the future pension payments are worth less today as the dollar devalues and the higher investment return drives the total present value of the payments down. To show this mathematically, imagine an individual with pension payments of $48,000 annually ($4,000 monthly), 20 year time horizon, and 5% interest rate. The present value of all of these payments is worth $598,186, which should roughly be the value of the lump sum payment. With a single percentage increase in interest rates from 5% to 6%, the new present value of the payments is reduced to $550,556, just under an 8% decrease over the old present value. Evidently, rising interest rates negatively affect the present value of future payments so given Federal Reserve Chairman Jerome Powell's mention of 2-3 more interest rate hikes this year, the decision of whether to take a lump sum now or later could have a big impact on your retirement.

In practicality, taking your pension as a lump sum and knowing how to manage your funds to last for your retirement requires hard work. Figuring out how much to withdraw, when to withdraw, and how much you can spend each year are just a few of the many decisions that are needed to be thought out in order to maximize the benefit of taking your pension as a lump sum. If you don't take the time to think out these decisions, you could find yourself running out of funds before the end of your retirement. For those who would prefer the safety of a guaranteed stream of income for the rest of their lives, taking the annuity over the lump sum may be the better option for you. With taking your pension as an annuity though, there is no certainty that the company paying your pension will remain in business for the duration of your retirement so you run the risk of receiving smaller pension payments from the PBGC (Pension Benefit Guaranty Corporation) in the event that your past employer goes under. Both options have their pros and cons and in the end up to you to decide which suits your personal financial situation and lifestyle.

For pension annuities that pay a fixed amount and don't adjust for inflation, the purchasing power of the each future payment decreases as inflation continues to rise. Given the long term inflation rate of around 3.22%, in a little over 22 years the pension payments will have devalued by 50%7. Average life expectancy after retirement (at age 65) worldwide is currently 20 years and growing so rising inflation is a huge factor to consider.. As previously pointed out, stocks provide the best inflation protection over the long run. Some examples of stocks to look into include high dividend and overseas stocks. The price of the high dividend stocks may not raise all that much but the high dividends allow for quicker reinvestment at these higher rates.

This strategy is a defensive approach but it allows investors to react accordingly to different changes in interest rates. Investing internationally is another good strategy because it allows the investor to capitalize on both the booms of other economies while also the appreciation of foreign currencies in relation to the U.S. dollar. For example, over the past 10 years the Euro has risen from $1.06 to the U.S. dollar to $1.23. A European investor whose U.S. stock gained 10% over the 10 year period is at a loss whereas a U.S. investor in European stocks made a profit even if those stocks fell 10% in value. These are just a few strategies to employ in order to beat inflation and earn solid returns with your retirement savings given current market conditions.

Conclusion

Managing your retirement savings wisely, regardless if you choose to take your pension as a lump sum or annuity, is critical to all retirees. If you believe you possess the knowledge and temperance to manage your pension as a lump sum, then perhaps that's the option for you. If the pension annuity payments are going to cover or exceed your expected monthly expenses, then the annuity option might be better for you. Ultimately, the decision of whether to take the lump sum or lifetime pension payments is up to your own financials and how you choose to manage your retirement. The main takeaway from all of this is that changes in inflation could make the difference in determining which pension option is right for you so it's important to meet with a financial advisor to figure out your plan of action.

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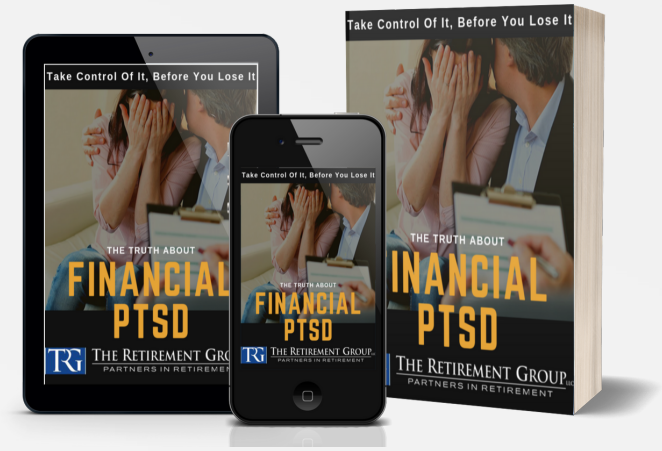
Value Investing Strategy



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