What is Inflation and the Investment Half-Life?

"Inflation" is the rate at which prices rise. Historically, it has been both volatile as well as unpredictable. The only certainty about inflation is that it robs all of us of the purchasing power of our investments – meaning that our buying power per dollar declines as prices increase.

For instance, I'm sure you've gone out to the movies, restaurant, or grocery store and thought, *"Wow, things have gotten expensive. I feel like I used to get way more bang for my buck."*

Well, that's because you did. And it's inflation's fault.

That's the insidious nature of the hidden **"inflation tax"** – your income may rise, but prices rise *faster*. Or worse, inflation may outpace your fixed returns (bond investors run into this issue as inflation is always a major factor when lending money or parking it in a savings account).

Some investors who have migrated into bonds have found that they received an after-tax yield that has simply not kept pace with inflation. **This is important because inflation - even low inflation - can take a bite out of the purchasing power of your savings over time.**

Thus, **"Investment Half Life"** is a useful concept that compares the impact of inflation to the present value of your assets.

In short, it shows you how many years before your current assets will lose half of their value or "purchasing power" at various levels of inflation.

To understand this further, look at the chart below:

Rate of Inflation	Investment Half Life
2% Inflation:[1]	36 Years
3% Inflation:	24 Years
4% Inflation:	18 Years
5% Inflation:	14 Years

An Example of Inflation and Investment Half Life

As an example, if we had 2% inflation, the current value of your investments would lose *half* of their value to inflation in 36 years. If inflation were 3%, it would take 24 years to lose half of your purchasing power to inflation.

A quick way to measure this is using **'The Rule of 72'** – which is a simplified formula for estimating the time it takes for an investment to double, or in this case, for the value of money to be halved due to inflation.

The formula is: year to halve = 72 divided by X inflation rate (per the above example; 72/2 = 36 years).

In our view, what's alarming is that many of the essential items such as food and energy prices have generally risen faster than core inflation (i.e. the change in the costs of goods and services but does not include those from the food and energy sector). As you can see, the half-life for your current savings is 17 years at 4% inflation and 14 years at 5% inflation.[2]

Investment Half Life is particularly difficult for retirees and others living on a fixed income because they do not have the benefit of rising wages to offset the compounding price increases.
In our view, having a portfolio that keeps pace with inflation is a valuable component of proper financial planning.

We believe that preserving the purchasing power of your current assets while protecting them from volatile markets is important, and yet, could be one of the most difficult undertakings facing investors today.

Speaking to a Financial Advisor may be the first step towards working through the issue of Investment Half Life.

Disclosures

[1]Source: www.bls.gov; Consumer Price Index, March 15, 2013

[2]Source: Dunham & Associates Investment Counsel, Inc. These examples are hypothetical only and may fluctuate with changes in inflation rates.
Investments are subject to risks, including possible loss of principal. Investors should consider the investment objectives, risk factors and expenses of any investment carefully before investing. Diversification does not guarantee profit or ensure against loss.