Investor Insights & Outlook

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Retirees: Inflation Protection for Retirement Portfolios

Retirees and pre-retirees have been challenged by the investing environment during the past few years. As it becomes harder to generate a livable income stream from retirement portfolios given the low bond yields, retirees have to choose between tapping their principal and venturing into high-yielding, but also riskier, securities. Investors are concerned about what could happen to their bond portfolios if interest rates were to rise. While inflation currently appears to be in line with historical norms, retirees remain concerned about the potential for rising inflation and its effect on their portfolios. Inflation-linked securities like Treasury Inflation-Protected Securities (TIPS) are the most direct way to hedge against inflation. But even investors who are convinced that TIPS are a good place to be still have questions about implementation.

Here is why inflation protection is important for retirement portfolios. Retirees miss out on some of the inflation protection that working people normally enjoy. Paychecks will generally trend upward to keep pace with rising prices but retirees don't have that safety net. Social Security payments are adjusted upward in an effort to keep pace with rising prices. But to the extent that a retiree is living off a portfolio anchored in fixed-rate investments, the payout from that sleeve of the portfolio will be fixed. If prices go up, the purchasing power of that portfolio, and in turn the retiree's standard of living, goes down. This is why inflation-indexed securities like TIPS, whose principal values adjust upward to keep pace with inflation, are an important part of a retiree's fixed-income portfolio.

TIPS are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. TIPS are subject to unique risks, most notably liquidity risk and inflation risk.

Advisor Corner

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Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the VP of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at www.brcapitalinc.com/newsletter.

Monthly Market Commentary

February saw markets continue to inch upward because of a temporary resolution to the Greek debt crisis. A second bailout was approved by European leaders, pending a bond swap in which private creditors are expected to accept a write-off that would significantly reduce Greece's sovereign debt. Also important was a reduction in Chinese bank reserve requirements, sending a message that the Chinese government is willing to do whatever it takes to prevent their economy from slowing too much. In the U.S., the disconnect between corporate earnings growth and economic growth continued to widen, as year-over-year GDP growth was relatively stable over the past year, while the S&P 500 year-over-year earnings growth decelerated throughout 2011.

GDP: Fourth-quarter real GDP growth was revised to 3.0% from 2.8%, with durable goods production and the rebuilding of depleted auto inventories still the two prime contributors to overall GDP growth. Warm weather, falling gas prices, and more auto production by Japanese auto transplants joined forces to artificially boost the fourth quarter. Morningstar economists believe that the 1.7% growth registered for the full year was probably more representative of trend-line growth than the sharp acceleration we saw in the fourth quarter.

Employment: February was the third straight month of solid job growth as employers added 227,000 jobs, mainly from a slower contraction of the public sector and the continued rise in private payrolls. In addition, both January and December job numbers were revised upwards (284,000 and 223,000, respectively), resulting in a net increase of 61,000 jobs. The unemployment rate remained at 8.3% as some previously discouraged workers returned to the improving labor market in search of jobs.

Manufacturing: After three consecutive months of improvement, the ISM manufacturing index for January declined slightly. January durable goods orders fell sharply from December, driven by weaker machinery and transportation product orders. Some of this weakness stemmed from the expiring tax incentive for full depreciation of capital goods, which expired at the beginning of 2012. Morningstar economists believe that while a stronger manufacturing sector provided a big psychological lift, at this stage of the recovery it is not going to be the key driver that it was earlier. The larger services sector has to do better at this point to sustain the recovery.

Housing: January's existing-home sales continued to show signs of life, growing to 4.57 million units, the second-best report in the last 18 months. To put that number in perspective, this metric peaked at 7.27 million units in 2005 and bottomed at 3.30 million units in July 2010. However, other than brokerage commissions, new furniture, and maybe an increase in remodeling expenditures, the existing-home sales statistic typically does not have a large direct impact on GDP, employment, or production, though it is a great indicator of long-term consumer confidence. The Case-Shiller pricing data for homes in December, on the other hand, was a disappointment and showed an accelerated decline from prior months.

Inflation: Commodity markets reacted strongly to positive economic data, with oil closing above $100 a barrel. (Iran's saber-rattling didn't help). Unfortunately, commodity inflation sours consumer spending. But U.S. inflation continued to improve despite the jump in gasoline prices, changing only 0.2% on a month-over-month basis (2.4% annualized). The primary reason inflation came in better than expected was because of a massive 2.9% decline in natural gas, cancelling out the well-publicized rise in gasoline prices.

Making the Most of Your 401(k)

Focus on Your Goal: It is very important to have a time frame for your retirement. Whether or not this comes to fruition, you'll want to plan for it. If your retirement is still more than 20 years away, you can probably afford to keep most of your plan in investments with a higher level of risk, such as stocks. While you will undoubtedly experience the ups and downs of the stock market, time is on your side. Just don't panic when the inevitable downs come your way.

On the other hand, if your retirement goal is right around the corner, you will most likely want to work on preserving your portfolio. In this case, it might be in your best interest to take on less risk. If you find yourself in a position to preserve your wealth, don't be afraid to shift more of your portfolio to less risky investments, such as bonds, or even cash.

Contribute Money NOW: Most people, at one time or another, have found themselves saying they just don't have the extra cash to contribute to their retirement. While this may be the case for some, contributing just 1% of your pay is a good place to start. Try your hardest to increase this rate every year, until you max out. Furthermore, if your employer provides any type of match to your contribution, saving becomes even more important. And contributions are made on a pre-tax basis, providing you with a very nice tax benefit by shaving money off your tax bill.

Choose Investment Options Wisely: When it comes to picking which investments will make up your 401(k), this can be quite a challenging task. You absolutely must understand your investment options and choose those that are right for you. Don't swing for the next home-run investment. When it comes to saving for retirement, consistent, positive growth wins. Asset allocation is one of the most important factors in determining both return and risk of an investment portfolio, so you may want to consult a financial advisor for guidance.

Be Careful when Changing Jobs: Most people only change jobs about every four or five years. But if you do switch, don't forget about the 401(k) from your previous employer. More importantly, do not take a cash distribution of your plan's balance. If you do this, you'll be starting from scratch and will have to pay early withdrawal penalties and income tax. You do have options, though. You may be able to keep the money in your prior employer's plan. You can roll the money over into the new plan. Or you can roll the money into an IRA. The important thing is that your savings will continue to grow and you will not have to incur any penalties or pay any taxes.

Resist Borrowing from Your Plan: Borrowing from your retirement account, except for extreme circumstances, is generally a very bad idea. As with taking a cash distribution, you are derailing your savings plan. If you are paying back your loan, it's going to be a lot harder to maintain your current contribution rate. And once again there are tax implications. If you have to borrow, try other alternatives, and preserve your retirement account if at all possible.

Keep Beneficiary Information Up to Date: Call your human resources representative and ask about your current beneficiary designations. Don't waste all that hard work saving money only to have it go to someone who's no longer a part of your life.

Investing in I-Bonds

When investors think about adding inflation protection to their portfolios, Treasury Inflation-Protected Securities (TIPS) are usually the top pick. But investors looking to add inflation protection have another option: I-Bonds. I-Bonds are Treasury bonds that pay a fixed rate of interest as well as another layer of interest that varies with the current inflation rate, as measured by the Consumer Price Index. I-Bonds are available only to individuals, with face values as low as $25. I-Bonds reach their final maturity 30 years after issuance, but investors can cash them in 12 months after purchase. If you redeem an I-Bond within five years of buying it, however, you'll forfeit three months' worth of interest. I-Bonds don't pay you income while you own the bond. Rather, the interest accrues and gets paid out when you sell or the bond matures. Because I-Bonds don't make regular interest payments, holders don’t pay any taxes until they sell or the bond matures. Therefore, if you plan to buy and hold an I-Bond for many years, it's fine to do so within a taxable account. This means you won't owe taxes on the accrued interest until you no longer own the bond. When you receive income from I-Bonds after they mature or you sell, you will owe federal tax but not state or local taxes. I-Bond proceeds to pay for college expenses are exempt from federal tax, assuming they (and their expenses) meet certain criteria. Because I-Bonds already come with an element of tax deferral, you cannot hold them inside an IRA. I-Bond purchases are currently restricted to just $10,000 per year. Because I-Bonds don't make regular interest payments but instead generate income when you sell, they're not a good option for those looking to fund living expenses with the current interest from the bonds. Because of their tax advantages, I-Bonds may be worth considering for investors' taxable accounts and can be held in conjunction with any TIPS holdings in a tax-deferred account.

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