

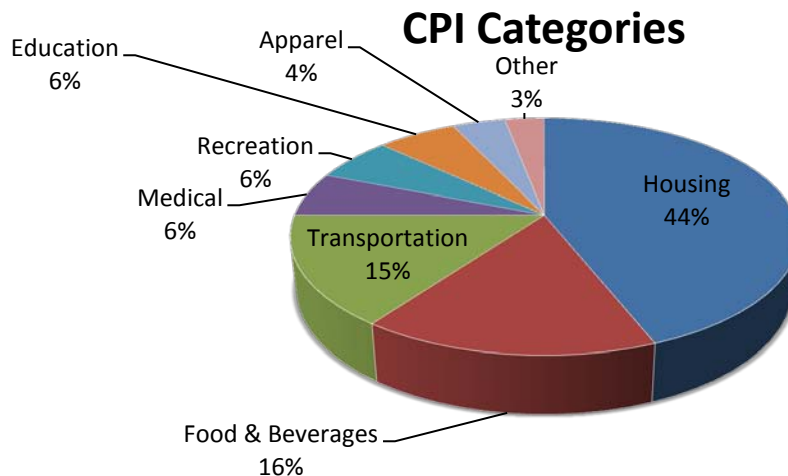
Deflated Inflation? Gregory A. Naylor 2/15/10

It is hard to overstate the financial trauma that investors have experienced in the last few years. As a result of the stock market crash of 2008-2009, many baby boomers have fundamentally shifted assets out of stocks and into bonds in an understandable desire for “safety.” Depending on the details of such movement, however, this may not be a wise shift. Despite the heartache associated with its downs, history shows that the ebbs and flows of the stock market provide the best way for the average investor to grow their money over the long run. The retiree in search of “safety” might be ill prepared for the biggest threat in the retirement income neighborhood: inflation, inflation, inflation.

What is the current rate of inflation? There are many answers. The most widely-used inflation gauge, the Consumer Price Index (CPI), rose 2.7% in 2009. However, while the CPI is probably not a perfect gauge of inflation, it might be particularly inaccurate for retirees. To explain why, let’s look at how the CPI is constructed.

THE CPI

The chart below shows the current weighting of the general expense categories in the CPI. As an example of how the weightings work, if the rate of inflation in the Transportation category is 10%, it would add a total of 10 times 0.15, or 1.5% to the overall rate of inflation. So price increases in the Housing category, which has a 44% weighting, obviously have the single greatest impact on the Consumer Price Index, followed by Food & Beverages, then Transportation, and so on.



As you can see, the ‘Medical’ category, which has a rate of inflation about twice as fast as the overall CPI, is a relatively small factor in the CPI. Most retirees, however, will probably spend more than 6% of their monthly budget on health expenses. Even if we ignore this obvious problem, the CPI has further hidden dangers for the retiree. Let’s look more closely at the two largest categories.

HOUSING

The Housing category of the CPI has increased at an annual rate of 3.8% from 1979 to 2009. However, the median price of a new home in the United States has increased in that same period from \$62,900 to \$215,900, an annual rate of 4.2%. Why would the CPI's cost of housing be growing 0.4% slower than the actual cost of a house? Well, the Housing category does not track the price of houses. Instead, it looks only at the monthly payments that are associated with housing, called rent or 'rental equivalence.'

Anyone who has a mortgage knows that your monthly payment is determined by two separate items. First is the price you paid for the house (principal), and second is the rate on your mortgage (interest). According to Freddie Mac, the average 30-year mortgage rate in 1979 was 10.39%. In 2009, it was 5.05%. So, although house prices have grown at 4.2% in the last 30 years, rates of interest have fallen in half, leaving the Housing component of CPI growing at only 3.8%.

A retiree who is a property owner probably 'feels' at least a 4.2% increase in the cost of housing, especially if they are close to paying off their mortgage. Years of low interest rates have driven up demand for housing related services, making maintenance and improvements more expensive for everybody. The cost of home maintenance is excluded from the CPI, as are property taxes. Oddly enough, they are also the main costs of housing for retirees who have paid off their mortgages.

FOOD

The problems in the Food & Beverage category are even more obvious than those with Housing. For example, the 'fruits and vegetables' sub-category carries a total weighting of 1.19%, while the 'alcohol' category carries a total weighting of 1.13%. Of the total 16% category weighting, less than 4% is devoted to fresh fruits and vegetables, grains, dairy and meat. Pop and other processed foods carry a weighting of almost 4%, while restaurant food is weighted at almost 7%.

Retirees who are buying themselves and their grandchildren soda and french fries will find these items to be relatively affordable. However, a retiree who eats a lot of home-cooked meals made with fresh ingredients, you might find your rate of inflation to be higher than the CPI's 2.7%.

QUALITY

Further, there is the issue of quality. The CPI does not adjust for the quality of materials and ingredients in the housing and food sectors. Remember, the housing sector only measures month-to-month cost of housing, so the materials used in building or maintaining a home are never a consideration. The infamous "Chinese drywall," according to the CPI, is the same as any other drywall, only less expensive. Correspondingly, there is no adjustment for food quality. A 2004 study from the University of Texas suggests that the average vegetable found in today's supermarket is anywhere from 5% to 40% lower in vitamins and minerals than those harvested just 50 years ago. These vegetables, according to the CPI, are the same as those eaten by your great-grandparents, only less expensive to grow. People who disagree are seeking out natural and organic foods, which are not part of the CPI's food index. Prices of organic food are growing at rates that are literally off the charts.

CONCLUSION

If your primary costs in retirement are going to be fast food and a mortgage, then your Social Security payments should ensure that your financial quality of life will not fall beneath its current level. If, on the other hand, your primary costs in retirement will be healthcare, home maintenance, and perhaps travel, then the CPI might be dramatically understating your personal rate of inflation. As difficult as it is to stay invested in the stock market, if you are approaching retirement, it has never been more important, especially if your rate of inflation is going to be 4-6% or higher.

Talk with your financial professional, get educated, and don't let fear be the guiding force in your investment decisions. There are good buying opportunities in the stock market, but my experience has been that a lack of understanding combined with an understandable fear is preventing most people from capitalizing on them.

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