Investing for retirement through high inflation

Five insights to keep in mind

challenger

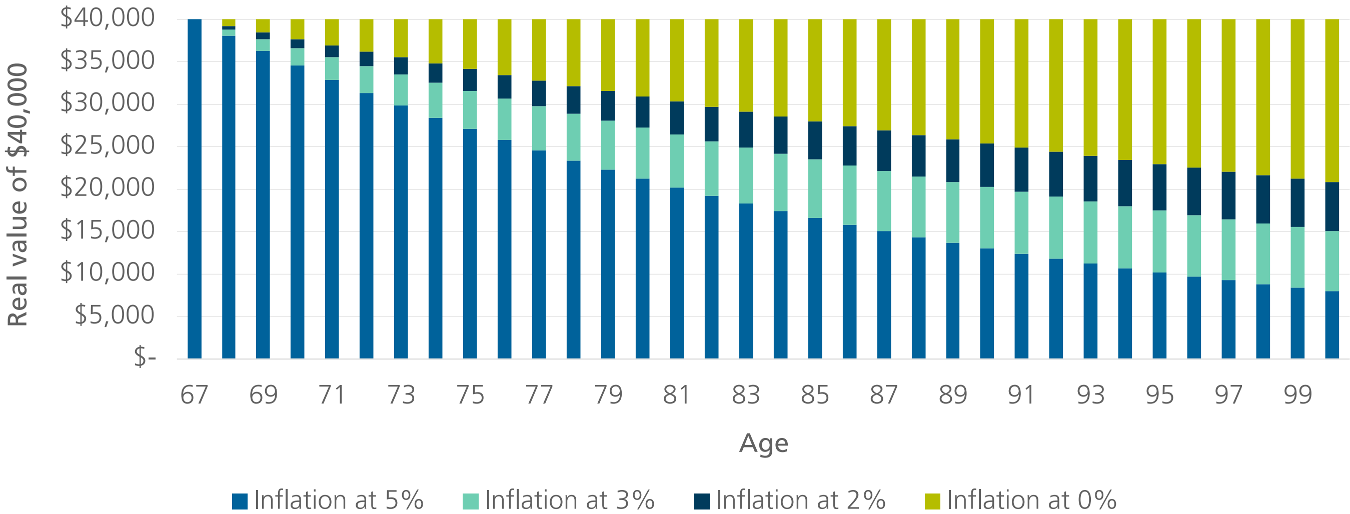
Rates of inflation – the rising costs of goods and services – in Australia are at levels not seen for decades.

The good news is that the recent Retirement Income Covenant requirements have led to greater innovation in solutions designed to help manage these risks. In this article, we present insights for you to keep in mind as you look at investment options in the context of rising inflation.

1. The impacts on income in retirement can be significant

Inflation has always been a consideration for retirees looking to manage their income in retirement. If the current high levels of inflation continue for years rather than months, retirees could face difficult spending choices. The chart below shows how inflation reduces the real value of income even at moderate levels. There isn't much difference in the early years, but the impact compounds over time. With inflation running at 5% a year, purchasing power for the same level of income is down by half after 14 years.

Figure 1: The impact of different inflation rates on retirement income



Sources: ABS, RBA occasional paper #8 and Table G6 labour costs (as released in 2012). Underlying wage data is from the ABS and is based on average male earnings.

Retirement lifestyle, and the income needed to support it, can change over time. As a result, some retirees find they spend less as they grow older which can potentially make up for a fall in purchasing power. Research by the Grattan Institute[1] has shown retirees tend to spend less (in real terms) over time. But this fall in spending is typically less than inflation, and retirees may not be able to make ends meet simply by reducing their budget for things like travel and dining out. If the cost of energy and groceries both increase, no one wants to find themselves having to choose between cutting back on essential heating or grocery bills.

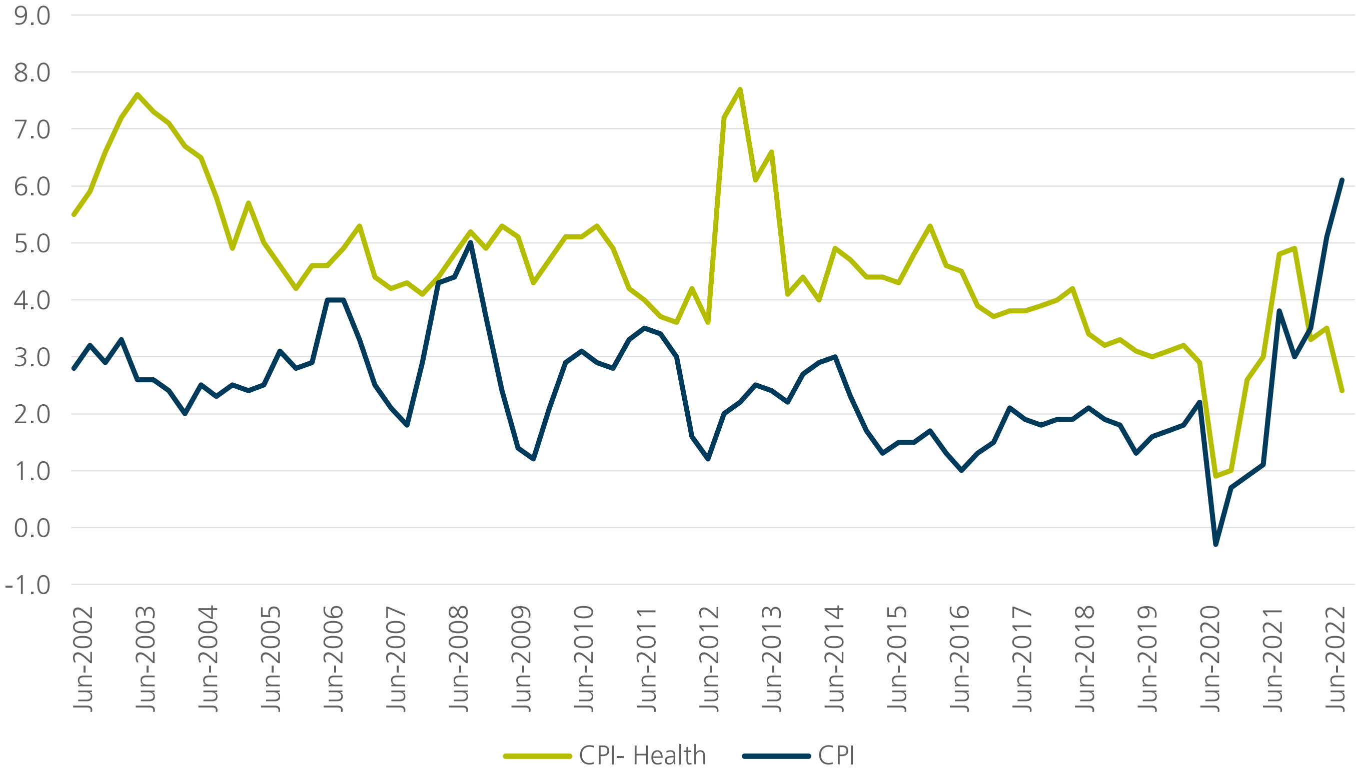
As retirees don't have the luxury of salary increases to keep up with rising living costs, they are particularly vulnerable to the impacts of a sudden inflation spike or longer period of higher inflation. This is compounded by the fact that retirees are now living longer and need to rely on income from their investments for longer as a result.

1 Daley, J., Coates, B., Wiltshire, T., Emslie, O., Nolan, J.and Chen, T. (2018). Money in retirement: More than enough.

2. Rising health costs could make matters worse

Medical expenses are a cost that will remain, and perhaps increase, later in retirement. A recent National Seniors member survey points to a high level of concern among retirees about meeting health costs from their income or savings[2]. Analysis does reveal that the health component of the Consumer Price Index (CPI) has been consistently higher than the overall CPI measure for the past 20 years as seen in the chart below, apart from the spike in overall inflation seen in 2022.

Figure 2: Annual Inflation: CPI and CPI-Health June 2002-2022



Source: Minney (2018)

While this trend suggests retirees' fears about health costs are justified, the picture may not be as negative as it seems. On average the increase in total spending on health is offset by reduction in other spending – on travel or entertainment, for example and a proportion of costs may also be covered by Medicare. For retirees who do have large out-of-pocket expenses to meet as their health declines, insurance can help limit the impact on retirement savings and income.

3. The Age Pension offers some protection

The Age Pension provides protection from inflation in two ways. The first comes from the indexation that happens twice each year to raise Age Pension payments in line with inflation. This increase can provide an enhanced benefit to retirees currently receiving a part Age Pension. Recipients of a part Age Pension will see their payments rise by the same dollar amount as the full Age Pension, so they will benefit from a higher proportional increase relative to their previous payments. As means test thresholds will also rise in line with either CPI or wages, some Part Pension recipients may receive an extra increase in their payments, or start receiving the Age Pension, if their income and asset position changes in relation to the new thresholds.

2 See The evolution of retirement income: A 2022 snapshot - National Seniors Australia August 2022.

4. Market exposure may not be enough to protect income

When it comes to investments, a safe harbour during a period of high inflation is hard to find. The table below summarises analysis of how effective four types of investment are in protecting investment returns from the impacts of inflation over time. For example, an investment in cash investment performs well initially but would only recover 80% of an inflation shock in the long term.

Table 1: Effectiveness of inflation hedges over different timeframes

Asset class	Short term (<1.5 years)	Intermediate (up to 5 years)	Long-term (5years+)	Long-run real returns
Cash	Not effective	Improving benefit	Largely effective	Modest
Nominal Bonds	Not effective	Losses decline	Not effective	Higher than cash
Equities	Not effective	Losses stabilise	Not effective	Highest
Commodities	Effective	Effect wanes	Not effective	Low

Source: Attié, A.P. and S.K. Roache,(2010) Inflation Hedging for Long-Term Investors; IMF Working Paper

Looking beyond these common investment choices, there are other options that are more likely to keep up with higher rates of inflation. Real estate, for example, may be a better option for inflation protection because the rent from a property can be expected to rise along with inflation.

5. Income stream options can help

Professional financial advice that draws on insights like these can help retirees to build inflation protection into an investment portfolio and manage risks to their capital. Managing the impact of inflation on retirement income streams requires a different approach. There are a growing range of retirement income stream options that can help retirees to achieve this goal.

Account-based pension

An account-based pension provides the most flexible option for retirees seeking to make income withdrawals that keep pace with inflation. A retiree can simply draw more money from one year to the next to offset the impact of inflation, subject to regulatory minimums. However, this can increase exposure to another kind of risk retirees face. There is a chance that they will simply run out of money if market returns are lower than expected or spending is higher than planned.

Guaranteed CPI-linked lifetime annuity

With this option, retirees receive an income stream for the rest of their life that adjusts in line with CPI changes. In Australia, the guaranteed annuity is provided by a life insurance company that is supervised by the Australian Prudential Regulation Authority (APRA). APRA aims to ensure that the life insurer maintains enough capital to pay the guaranteed amounts to the annuity holder, no matter what happens in markets or how long they live.

Market-linked lifetime annuity

As a relatively new development in annuities, market-linked lifetime annuities provide payments that increase in line with the performance of either an underlying diversified portfolio or a defined group of market indices. The payments will change as markets move, falling at times as well as increasing. These solutions can potentially provide adequate inflation protection for a retiree's income. On average, over the long term, annuity income can be expected to increase by more than inflation. However the payments cannot be relied on to always grow faster than the CPI and there is also sequencing risk to consider – payments could take a long time to recover from a decline in markets early in retirement.

As more income stream options become available, retirees have more choice when it comes to managing the impact of inflation on their retirement income. They can opt for different levels of inflation protection, from none to a guaranteed CPI-linked option to approaches that should work but still involve some market risks. Plus there is the option to change how much they draw down on their capital, adjusting for inflation as and when they need to.

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