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KEEPING PACE WITH INFLATION

LIFE BEYOND WORK

Ruth Strachan, consumer editor at BNY Mellon Investment Management sits down for a conversation with head of retirement, Richard Parkin about why it's important to keep pace with inflation when you are considering your retirement income strategies.

KEY TAKEAWAYS

- Inflation impacts everyone but it is important to build a retirement strategy that is able to keep pace with inflation.
- This can be particularly important for people looking to take an income from their retirement savings.
- Specific investment products, such as inflation-linked gilts*, may be able to support your retirement plans.

* Fixed income securities issued by the UK government where both the value of the loan and the interest payments are adjusted in line with inflation over the life of the security.

Conversation took place 9 April 2024.

Ruth: **Hi Richard, today we're talking about inflation and how that might impact those saving for and in retirement. But inflation is something that everyone can be impacted by. I'm sure many are familiar with the term but what does inflation actually mean?**

Richard: Hi Ruth. Well, I suspect most people are tired of hearing about inflation, so I'll try and keep it quick. Basically, inflation is a measure of how fast the cost of living is rising. This includes the costs of goods like food, and services like haircuts, but will also usually include the cost of housing and other items such as council tax.

Inflation is usually measured by the change in these costs over a 12-month period and is based on a typical mix of goods and services. So, when we hear that inflation is at 5%, it means that prices on average have gone up by 5% compared to where they were a year ago. On average, what cost £100 a year ago now costs £105.

Ruth: **So, inflation means prices are going up. Does that mean when inflation is falling, prices are coming down?**

Richard: Not really, I'm afraid. Inflation is a measure of how much prices are increasing over time. When inflation is rising it means that prices are going up more quickly. When inflation is falling it means that prices are still going up but more slowly.

If we look at what's happened in recent years, inflation went up sharply meaning that prices were rising rapidly. Inflation then started falling which meant that prices still went up but just a bit more slowly. From the end of 2021 to the end of 2023 the cost of living, as measured by the Retail Prices Index, was up nearly 20%.

It's only if inflation turns negative, something we call deflation, that we can expect to see prices fall. While some prices do come down, deflation is not something we see very often and can actually be very bad for an economy.

Ruth: **Obviously no one wants a more expensive food shop or high inflation generally, but what does it mean for people in retirement?**

Richard: There are two ways to think about inflation. The first is to think about how much I might need to spend to buy something in the future compared to how much it costs today. As a simple example, if the price of a kilo of apples is £2 today and the price goes up by 10% then I'll need £2.20 to buy that kilo of apples.

The other way to think about it is how much of something I can afford to buy with a fixed amount of money. This is often referred to as purchasing power. In my example, if the price of apples went up by 10%, my £2 would only buy me just over 900 grams of apples. That is, I get less for my money. My purchasing power has fallen.

Ruth: **And that could be a problem for someone in retirement…**

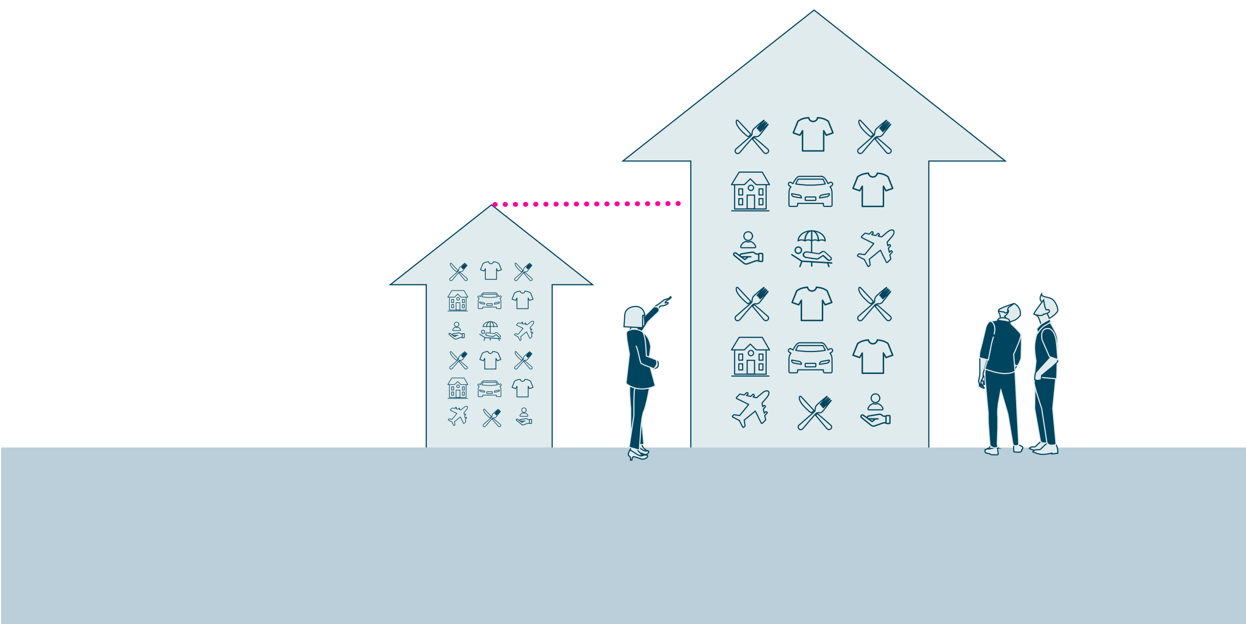
Richard: Absolutely, if I'm living on a fixed income that doesn't go up with inflation, then my income will buy me less and less over time. So it's important to think about what inflation could look like for you and whether your income will keep up with inflation over time.

Ruth: **There are a couple of points there that I'd like to explore. The first is what inflation looks like for you and the second is whether income keeps up with inflation. Let's start with what inflation looks like for you. What does that mean? Surely inflation is the same for everybody.**

Richard: Well yes and no. Generally, we'll all pay the same price for the same thing. A kilo of apples is the same price for me and for you. But what if I don't eat apples and you love them? If the price of apples goes through the roof, I won't care, but you'll need to spend a lot more on apples or alter your apple intake.

Similarly, I might drive a big car while you go everywhere by bike. If the price of petrol soars, then that's going to affect me, but will have less impact on you. Everyone will be impacted by inflation differently depending on the goods and services they buy and how much the prices of those goods and services change.

What's happened recently is that inflation has been driven by higher food, energy and fuel costs which has impacted everyone.



Ruth: **For the record, I don't think I should be trusted to travel via bike anywhere – I'm far too clumsy. But can we go back to having income that keeps up with inflation. State pensions and other benefits tend to be linked to inflation already, don't they?**

Richard: Yes, they do. In fact, State Pensions are even better protected because they are subject to what's called the triple-lock. This means that they go up each year by inflation, the increase in average earnings or 2.5%. This means that State Pensions not only keep up with the cost of living, but they also grow in line with average wages so, if the economy is growing and workers are getting pay rises, pensioners benefit too. And if prices and earnings aren't growing much, then those on State pensions could still see their incomes rise. This is good news for pensioners though it's not clear whether the triple-lock will be around forever. Both main political parties have said they'll continue with it for the time being but it's a very expensive policy.

Ruth: **What about guaranteed pensions from work?**

For people who have guaranteed pensions from work, these also tend to increase each year but may not always keep pace with inflation. Some will increase in line with inflation but be capped at a certain level, say 5% each year. Also, increases may not always be guaranteed. So, while these pensions may keep up with modest inflation, they could see their purchasing power fall.

For those looking to take income from their retirement savings, making sure that income keeps pace with inflation can be really important.

Ruth: **So we've outlined that keeping pace with inflation will likely be a priority with our retirement savings, but what does that actually look like?**

Richard: It depends on how I'm looking to use my savings. If I'm buying a guaranteed income, also known as an annuity, I can choose to have my income increase each year. This could be at a fixed rate or in line with inflation. However, choosing an annuity that has increasing income will cost you more or, put another way, will mean you have a lower starting level of income.

As an example, at the end of February 2024, a 65-year-old in good health with £100,000 to invest could get an annuity of around £6,400 a year with no increase. If they chose to have their income increase by 3% each year, they would start on just under £4,400 a year, so £2,000 a year less, and if they wanted their income to keep pace with inflation their starting income would drop £550 or so to just over £3,800 a year. Rates may vary but this shows what an impact having increasing income can make[1].

Of course, people might be tempted by taking the higher rate with no increases, and many are, but that would mean that their purchasing power would fall over time and could see a big reduction if inflation spiked again.

Ruth: **You mean they'd be able to afford fewer apples?**

Richard: Exactly right. If they had other income that was inflation-linked that might not be too much of a problem. Generally, people tend to spend less as they get older and less active so may be able to cope on less but that's not always the case.

1 Annuity rates from MoneyHelper. Rates shown are the best rate quoted for a 65-year-old in good health assuming monthly payments in arrears, a 10-year guarantee period and a dependant's pension of 50%. Rates obtained on 15 March 2024.

Ruth: **What if I'm keeping my savings invested and taking an income from them. How might I protect myself against inflation?**

Richard: Well, if prices rise and you need more income to support your lifestyle, you can take more from your savings. The problem is that taking more means you'll use up your savings more quickly all other things being equal. Depending on how much you have saved, this may be OK, but typically we want our savings to grow in line with or faster than inflation to help them last longer.

Some investments, such as index-linked gilts (UK government bonds or debt investment instruments) are directly linked to inflation so can help but may not give much scope for additional growth. Investing in company shares is traditionally expected to provide some protection against inflation in the long run but comes with other risks. In particular, there is always a potential for the value of investments to fall and returns may not always match inflation in the near term.

Ruth: **It sounds like inflation can be a real problem for people in retirement. What can people do if they are worried?**

Richard: Inflation can certainly have a big impact on people's standard of living and those in retirement can be particularly vulnerable to it as they tend to be living off finite resources. Working with a financial adviser to create a sustainable spending and investment plan can help make sure that you're able to withstand the impact of inflation whatever that may be.