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BLOWN UP BY INFLATION

Ask the average man/woman on the street to define inflation. The answer will be something like "it's when things cost more."

Ask them what causes inflation. The responses will range from a stammering "I dunno" to a rambling list of conspiracy theories (the government, big corporations, international cartels, etc.).

Ask them what they can do about inflation. Most people will say "nothing."

PART I: What is inflation?

Inflation is a "stealth" economic force at work in our lives that impacts all of our financial transactions.

A simple, commonly used definition of the word inflation is "an increase in the price you pay or a decline in the purchasing power of money." In other words, "it's when things cost more."

In the U.S., inflation has been a fairly constant financial fact of life for the past century. According to the data published on *inflationdata.com*, the average annual inflation rate from 1913 to 2007 has been 3.42%. Thus, on average, an item that costs $1,000 today will cost $1,034 a year from now.

The rate of inflation (as measured by government standards such as the Consumer Price Index) fluctuates, and may even decline (this happened in the 1920s and 1930s). The current annual rate of inflation for the United States has been calculated at between 5 and 6%, depending on the criterion used for calculation.

However, it is sobering to note that the cumulative result of a "low" inflation rate is still astonishing. In the case of the U.S., the compound effect of a 3.42% annual inflation rate from 1913 to 2007 is a total inflation of *2071%*! Thus, something that cost $1.00 in 1913 would cost $21.71 today ($1 + $20.71 inflation). Or conversely a dollar today is only worth 4.8¢ in 1913 dollars. (Given the same rate of inflation for the next century, something that cost $1.00 in 1913 would cost over $400 in 2108.)

PART II: What causes inflation?

There are two causes of economic inflation: 1) An increase in the money supply; and 2) an increase in the demand for goods and services.

The most consistent and ongoing cause of inflation is an increasing money supply. Most nations attempt to control their money supply by designating to central banks the authority to print and regulate the national currency as they see fit. In general, an increase in the money in circulation will result in higher prices, because when there's more money to buy stuff, people will be willing to pay a higher price to make sure they can get what they want.

In the United States, Congress has designated the Federal Reserve to serve as the financial authority for the nation. (This is why all United States paper money has the words "Federal Reserve Note" written on the top of the bill.) The Federal Reserve determines how much money will be circulated, and what the interest rates will be for member banks to use this money. When you hear or read reports regarding Federal Reserve Chairman Ben Bernanke's comments on "controlling inflation," it's because the Federal Reserve can influence the rate of inflation by managing the money supply.

The other cause of inflation is either an increase in demand and/or decrease in the quantity of available goods. When more people want something or there is less of it available, the result will be inflated prices. For example, the sharp increase in gasoline prices over the past year is due largely to diminished supply (because of natural and political events like hurricanes and wars)

Financial Literacy Question

(See page 6 for the answer.)

Here's a quick quiz on a basic financial concept. Do you know the answer?

If inflation averages 6% a year, how long will it be before a $1.00 candy bar costs $2.00?

___ **A.** 18 years ___ **B.** 15 years ___ **C.** 12 years

and increased demand in growing economies such as China and India.

PART III: What are the consequences of inflation?

It depends on which action (increased money supply or increased demand for goods) is causing the inflation.

Monetary inflation usually encourages spending, and most government economists see increased spending as a way to keep the economy rolling. This is the rationale for the government issuing Economic Stimulus checks: put money in the economy, and let people spend it.

Ongoing monetary inflation also encourages borrowing, and discourages saving. If inflation is going to make today's money worth less in the future, it makes sense to buy now, but make payments later. Again, an example may be helpful: Even at just 3% annual inflation, a $500,000 house will cost $515,000 next year. And a $3,000-a-month fixed mortgage payment on a 30-year mortgage will actually cost less than $3,000 in the future. Given these realities, inflation gives consumers a rational incentive to buy today, even if they have to borrow to do it.

When inflation is the result of an increased demand for goods, the most likely consequence will be increased competition or the development of alternatives. Ultimately, inflation as a result of increased demand may even result in lower prices in the future.

For example, high gasoline prices may make it attractive for new players to enter the market. The situation may encourage the development of new extraction methods, or cause people to reconsider drilling in the Alaskan tundra. As gas prices go up, alternative fuels and transportation modes may become more competitive. In some situations, the alternatives may eventually become the product of choice – hydrogen might someday replace oil, just as 8-track tapes were replaced by cassettes… which were replaced by CDs, which are being replaced by iPods and Internet downloads.

Sometimes the innovation and productivity sparked in response to increased demand for a good or service can override monetary inflation. In 1972, Texas Instruments introduced a rudimentary portable computer that could perform four arithmetic basic functions – addition, subtraction, multiplication, and division. This hand-held calculator retailed for $119.95. Adjusted for inflation, that $119.95 calculator would cost about $850 today. But today, $850 will buy a good laptop, and a hand-held calculator can be had for 50 cents at the counter of your local gas station. Even with monetary inflation, the price of portable computing devices has dropped precipitously.

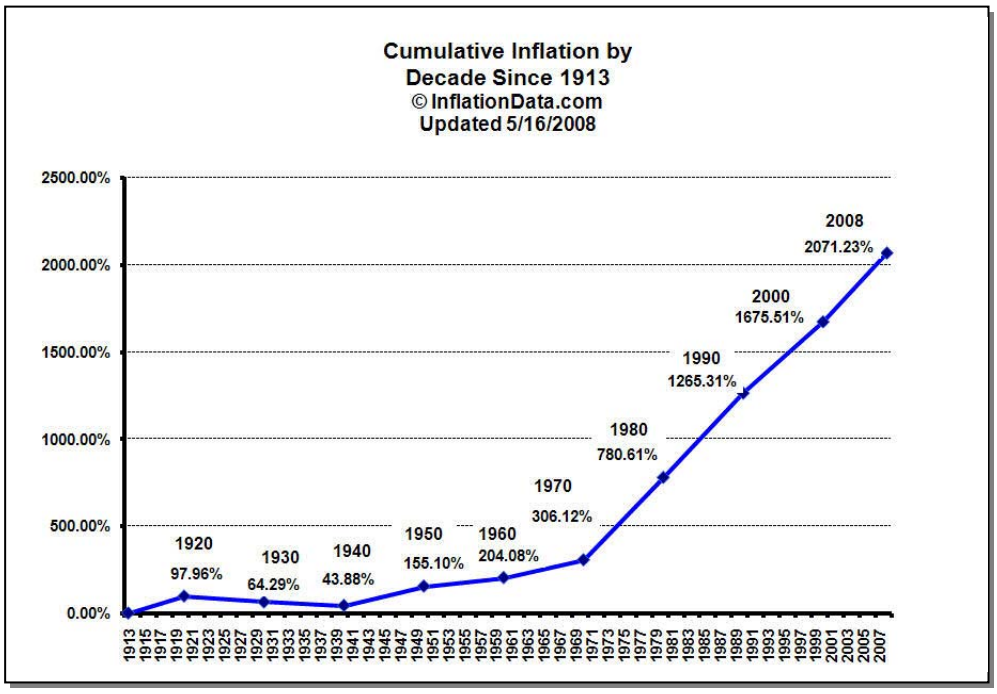
PART IV: What's the problem with inflation?

Inflation diminishes the purchasing power of our money, but there's some debate as to how damaging inflation is to individual finances.

Most economists agree about the reasons for, and the outcomes of material-good inflation. If people want more of something, or if there's less of it available, the market eventually finds the best ways to meet the demand. Along the way, new technologies may arise and old businesses may close. Inflation here is part of the "invisible hand" of capitalism, eventually leading to a higher standard of living for most people.

However, the opinions about the value of monetary inflation vary greatly.

Some see monetary inflation as a method for providing the right incentives for everyone to keep spending, since spending keeps people employed, which allows for more spending, etc. (For a more in-depth critique of this perspective, see the "Paradox of Thrift," article in our February 2008 issue.) Others view monetary inflation as benign manipulation – in the end, nobody really gets hurt. Still others, such as Murray Rothbard and the Austrian School economists, see inflation as a form of counterfeiting because the first parties in the act of monetary inflation are the ones who benefit most. The immediate beneficiaries of monetary inflation are governments and banks, and in repeated government-sponsored inflations, the worker never quite catches up. Prices go up before wages, thus the working American



is always a little bit behind.

As long as the erosion of our purchasing power is minimal, inflation is a nuisance we learn to live with. When monetary inflation is low, wages eventually increase as well, and people adjust. Likewise, when inflation due to increased demand isn't too steep or too fast, most people have time to find alternatives or make changes.

But when the rate of inflation gets high, or when monetary and increased demand inflation are combined, people start to feel some intense economic pain. Some events from the past two years are good examples.

The sub-prime mortgage mess came about because too many homeowners couldn't make their mortgage payments. When banks can't collect payments on their existing loans, they don't have the funds to make new loans, and they can't pay interest to their depositors. If depositors decide to cash out, banks will close. If too many banks close, the monetary system is no longer functional.

To preserve the integrity of the United States financial system, the Federal Reserve decided to "loan" banks enough money to stay in business, and hopefully give them time to recover their mortgage losses. While the loans may have averted a financial meltdown, one of the side effects of this infusion of cash was inflation. The Aug. 19, 2008 *Wall Street Journal* noted that the Labor Department said the producer price index for finished goods jumped 1.2% on a seasonally adjusted basis in July. 1.2% per month is equivalent to an inflation rate of more than 14% annually.

Combine this relatively steep monetary inflation with the increased worldwide demand for fuel, and it's a financial double whammy. Basic standard-of-living items cost more, and since incomes are not increasing fast enough, people stop buying things. When no one is buying, businesses respond by lowering prices, cutting production, closing stores or laying off workers. That's a storyline you've seen repeated at Starbucks, General Motors, Bennigan's and a bunch of other businesses.

It's also what's happening in the residential housing market. On August 9, 2008 *Newsweek* reported that the average U.S. home has lost 16% of its value in the past year, and that the number of houses sold has dropped by one-third since the market peak in 2006. Prices are down and there are fewer people who can afford to buy a home.

PART V: What can you do about inflation?

1. Plan for it.

As a consumer whose wages may eternally trail the price increases caused by monetary inflation, you may detest inflation. But since both democracies and dictatorships practice monetary inflation, it's not like you can get away from it. You have to face it.

If you entered the workforce 25 years ago, $20,000 a year might have represented a very respectable starting salary. Today, you probably need $75,000-$100,000 to make it. And tomorrow, you're going to have to increase your income even more. If your income isn't going up, you're going down. That's the nature of inflation.

This is true in retirement as well as during your working years – each year will require more income to maintain the same standard of living. A static "conserve-principal-live-on-the-interest" approach won't work, because the principal needs to increase every year as well. This is why financial professionals often calculate retirement scenarios using a projected rate of inflation. (For more on this issue, see the box on Page 2.)

Also, many types of insurance (such as homeowner's, disability income and life) usually offer some types of inflation-protection options.

2. Watch for the Bubbles – and Avoid Them

Wherever there is high inflation, there's also the likelihood of a financial "bubble" – rising prices that are so inflated they cannot be sustained. Remember that monetary inflation encourages borrowing. When people are willing to borrow large amounts to invest in "sure things," it's often an indicator that the bubble is about to burst.

In Charles P. Kindleberger's 1978 classic, *Manias, Panics and Crashes: A History of Financial Crises*, the author describes the end result of most periods of high inflation: "What happens, basically, is that some event changes the economic outlook. New opportunities for profits are seized, and *overdone*, in ways so closely resembling irrationality as to constitute a mania." In other words, people see a good idea, go crazy over it – and burst the bubble.

This is a perfect explanation of the recent mortgage crisis. Banks, homeowners and investors all saw great opportunities in residential real estate, opportunities so great they were willing to engage in risky loans in order to get in on the action.

3. When the Bubble Bursts, There May Be Great Bargains

Dean LeBaron, a noted institutional investment manager, states, "When the bubble bursts, people of wealth and credit scramble to unload whatever they have bought at greater and greater losses, and cash becomes king."

What will those opportunities look like? Every situation is different. For example, some individuals with available cash have scooped up foreclosed homes at deep discounts. It's impossible to know where the bottom will be in residential real estate, but those with cash are the ones who could seize the opportunity.

4. Keep Saving – But in the Right Places

Inflation makes it harder to save, because inflation often rewards short-term buying and long-term borrowing. But if you want to get the bargains you will have to accumulate savings – even if the current rate of return on this money is less than the rate of inflation.

One of the keys to beating inflation is the ability to reposition your assets according to the changing financial landscape. There may be times to buy a real asset (like a home) and times to hold cash (getting out before the bubble bursts).

In this regard, while it's true that qualified retirement plans have many attractive features and tax advantages, some of the restrictions (withdrawal penalties, investment choices, etc.) may not allow the flexibility to fully capitalize on inflation-related opportunities.

HAVE YOU FACTORED INFLATION INTO YOUR FINANCIAL PLANS?

ARE YOU PREPARING TO EARN MORE, AND SAVE MORE, AS TIME GOES ON?

ARE SOME OF YOUR ASSETS POSITIONED WITH INFLATION IN MIND?

(CONTACT US FOR IDEAS TO HELP YOU OFFSET THE RISKS OF INFLATION.)

DIFFERENT ITEMS, DIFFERENT RATES OF INFLATION:

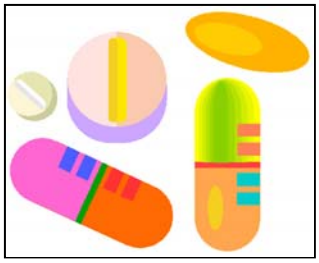
When planning for retirement you can't just use the Consumer Price Index

One of the sections of this month's lead article mentioned how financial professionals often include a projected rate of inflation when constructing potential retirement scenarios for their clients. Based on historical models, many advisors will use an inflation rate between 3 and 5%. While this is only an estimate, the number still attempts to reflect the economic realities retirees will face when they stop working and start living off their accumulated savings. But there could be a problem.

The costs associated with drugs and medical care, which are some of the largest expenses incurred by retirees, have outpaced the general inflation rate for the past 20 years. A report from New Retirement (www.newretirement.com) notes that health care cost "increases are expected to continue in the years ahead. Some industry surveys predict that costs will rise as much as 15% annually. This growth will double the cost of retiree health care in just five years."

Aon Consulting Worldwide reported in an August 2008 press release that "the cost of prescription drugs has increased 87% in the last 5 years, an average annual increase of more than 13% compounded per year."

Rising medical costs are primarily a result of a growing senior population with an ever-increasing need for medical attention.



The New Retirement report goes on to note the amount of medical attention received increases dramatically for seniors as they get older – for those over age 85, medical costs can consume, on average, 30% of the retirees' income.

Since the boomers are just beginning to reach retirement age, it seems likely that the demand for medical care for the elderly will continue to increase over the next decade. That's sobering. But when you attempt to make a projection putting these two pieces together – high medical costs combined with a high inflation rate for services, the calculation can be scary.

Begin with an annual after-tax retirement income of $100,000. Suppose you assume that 15% of your income in retirement will be devoted to medical expenses. Assume that the inflation rate on that portion of your cost-of-living will experience an annual inflation rate of 15%, as mentioned above. Assume the remaining 85% of your expenses will grow at a 4% annual rate. Here's what your cost-of-living looks like in Year 1:

	Medical Expenses	Other Expenses	Total Expenses
Yr 1	$15,000	$85,000	$100,000

Now look at Year 2. Medical Expenses increase by 15%, while all others increase by 4%...

	Medical Expenses	Other Expenses	Total Expenses
Yr 2	$17,250	$88,400	$105,650

Because of the high inflation rate for medical expenses, the overall rate of inflation is 5.65%. And medical expenses comprised 16.32% of all expenses, not 15% as in Year 1.

Playing this scenario out over several years, the numbers get worse:

	Medical Expenses	Other Expenses	Total Expenses	Inflation Rate
Yr 3	$19,387	$91,936	$111,323	5.80%
Yr 4	$22,813	$95,613	$118,426	5.95%
Yr 5	$26,235	$99,437	$125,772	6.12%
Yr 6	$30,170	$103,415	$133,585	6.30%

Not only is your annual inflation rate creeping up, but in Year 6, medical expenses now consume 22.5% of all income.

Considering the numbers generated from this simple exercise, it's no wonder financial professionals are now advocating upwards of $150,000 of retirement savings be allocated exclusively to paying medical expenses. The combination of demand and price inflation makes this item a potential deal-breaker in your quest for financial security.

BRAVE NEW WORLD: USING A LIFE EXPECTANCY REPORT TO SHAPE YOUR FINANCIAL DECISIONS

What if someone could tell you with 96% accuracy how long you would live? Would you want to know? How would this knowledge affect the way you live your life? Would it change the way you used your money? These are some intriguing questions that arise from a relatively new actuarial process called a Life Expectancy (LE) Report.

What are Life Expectancy Reports?

LE reports are a special form of risk assessment currently offered by five or six appraisal firms in the United States. Most of their LE assessments are made in conjunction with viatical and life settlement transactions, but it is possible for an individual to request a life expectancy report.

A viatical settlement is the sale of a life insurance policy of a terminally ill individual to a third party. Typically a viatical settlement involves a person who has a life expectancy of less than 2 years. A life settlement is the sale of a life insurance policy to a third party, where the insured individual does NOT have a known life-threatening or terminal illness or condition. In both situations, the policy owner receives cash immediately for the sale of the policy.

The amount paid upon the sale of the policy to a third party is based on a life expectancy (LE) report. All things being equal, the lower the LE report, the higher the payout to the seller of the policy. These reports typically calculate life expectancy in terms of months, as opposed to years.

Over time, these specialized medical underwriting firms have developed several proprietary formulas for calculating LEs. By analyzing pools of 200 or more individuals, these firms claim to be able to project the mortality of individuals with plus or minus 10 percent accuracy. One company even boasts a documented 96% accuracy in their LE reports since 2000.

How is an LE report compiled?

An LE report is assembled by assessing several factors such as:

- **Sex** (females are expected to live longer than males)
- **Genetics** (some people are predisposed to living longer than other people)
- **Lifestyle choices** (smoking, drinking, using drugs, engaging in dangerous activities or jobs)
- **Availability of advanced medical technology**
- **Access to clean drinking water, better nutrition**
- **Geographic location** (some parts of the country have higher life expectancies than others)
- **Current age** (the older you are, the more dangers of death you have survived, and the higher your LE!)

The LE appraisers use family medical history, attending physicians' reports (APSs) from doctors seen by the insured, records of all attending physicians (including specialists), and a preliminary application to gather the necessary data. It is common for the data used in compiling the report to run to several hundred pages. A typical LE report may cost between $200 and $500, and can usually be processed with 8-10 days (although one company promotes a 48-hour turnaround time for life settlements).

How could LE reports influence financial decisions?

According to articles that appeared in the April 2008 *Agent's Sale Journal* and the July 8, 2008 InsuranceNews.net, some financial professionals have begun using LE reports in developing financial strategies and managing the retirement assets for senior individuals. This may include determining their client's allocation of investments, or the selection of an annual withdrawal rate for retirement income. Instead of using general rules of financial allocation, the LE report can be used to produce plans more precisely structured to fit the client's situation.

For example, if a healthy 70-year old receives a much higher than normal LE report, this knowledge could change some of his investment and asset allocation decisions. He might consider more investment risk believing he has a longer time horizon. He might consider a lifetime annuity, knowing that the odds are in his favor that he will live long enough to see his monthly payments far exceed his initial investment.

Do LE reports have a "dark side?"

Here's the headline from an August 4, 2008 article posted by Forbes on-line (www.forbes.com):

Both Major Presidential Candidates Can be Expected To Remain Healthy for Two Full Terms, International Actuarial Firm Finds

The LE report, prepared by Bragg, an actuarial consulting firm based in Atlanta, put forward the following life expectancy information:

- Democratic presidential candidate Barack Obama, age 47 today, has a health expectancy of 21.9 years. The analysis accounts for his history of cigarette smoking, which continues into 2008.
- Republican presidential candidate John McCain, age 72 on August 29, has a health expectancy of 8.4 years. The analysis accounts for his history of four occurrences of melanoma of the skin.

"Either candidate can be expected to serve two full terms, without age or health being an issue," said John M. Bragg, chairman of Atlanta-based Bragg.

"Our evaluation takes into account each candidate's age and known health impairments, as disclosed in reports of medical records," Mr. Bragg noted. "In this analysis, 'healthy' means the person does not require the care provided by an assisted living facility and is free of Alzheimer's disease."

The article concluded with some very provocative comments:

This type of health expectancy profile has the potential to become a standard in political campaigns. "The people of America need to know their president will stay healthy," said Mr. Bragg. "It is a public service to show the health of the two candidates."

No one lives forever, but it's a little unsettling to think there's someone who claims they can determine with 96% accuracy how long you will live. And if others knew your LE – and believed it – how might it affect their perception of you?

For example, what if the data found that McCain's LE was only 3.4 years? Would that information be enough to exclude him from consideration as president?

What if executive searches included an LE test to see how long a prospective CEO would live? Is it possible that a low LE might result in discrimination against a particular candidate?

Could a low (or high) LE be self-fulfilling? If you believe you're supposed to live until 90, doesn't that positive belief increase your odds of actually living that long? Conversely, will you be more likely to die at 91, since you've already exceeded your expectations?

ANSWER TO THE FINANCIAL LITERACY QUESTION ON PAGE #1

Answer: C. This is an application of the "Rule of 72," a simple way to calculate the time it takes for money to double at different annual rates of return. To determine how long it will take for money to double (i.e., for $1 to grow to $2), you simply divide the annual rate of return into 72. The answer is the number of years it takes for the money to double at that rate. Using a 6% annual rate of return, the number of years to double is 12 (72 ÷ 6 =12).

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