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. Inventors 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 portfolio 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.

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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.

Six Reasons Why Boomers' Retirement Is Different From Their Parents'

1. Much Longer Retirement: Many people in previous generations worked as long as they could and very few were fortunate enough to have a retirement that would be considered "golden" by today's standards. How many spent the last third (or more) of their lives pursuing hobbies and leisure instead of working? Boomers retiring in their 60s can expect to live about 30 years in retirement, which is a lot longer than their parents did.

2. Higher Expectations: Not considering tours of duty in Europe or the Pacific, how much traveling did past generations of retirees do? Boomers' parents were Depression-era babies who practiced frugality and continued to pinch pennies throughout retirement. In stark contrast, boomers want their retirement to include travel, vacation homes, new cars, dining out, etc. This is fine, but it is expensive. Therefore, boomers need to plan for a much more expensive retirement than their parents ever would have expected.

3. Personal Savings Instead of Pensions: The greatest generation might have had a lower per capita income but many also had corporate pensions. Boomers wanted higher salaries, freedom to change employers and the ability to save independently. Corporate pensions were largely phased out, giving way to the 401(k). However, when given the option, most boomers didn't start saving enough or early enough. Today, many boomers haven't amassed enough in personal savings, and most don't have meaningful pensions compared to their parents.

4. Rising Instead of Declining Interest Rates: In the 1980s, when the greatest generation started to retire, interest rates were much higher than they are today. The long decline in interest rates provided a great return to bond investors. The boomers are facing the very opposite situation. Instead of an ever-declining interest rate, they are facing the likelihood of steadily increasing interest rates during their retirement.

5. Exotic Investment Options: The greatest generation had relatively few investment options; mostly ordinary bonds and certificates of deposit. Today's boomers, on the other hand, are being offered an ever-expanding universe of income securities. The investment industry has provided a lot of rope, and a lot of new and exciting ways to lose it all.

6. Deregulations: If they felt like taking risk, the boomers' parents might buy some dividend-paying stocks. At the time, most of the dividend-paying industries, such as finance and utilities, were highly regulated. Decades of deregulation have caused these industries to become less predictable and more risky; hence, the certainty of previously assumed dividends is now extremely uncertain.

What Boomers Really Need: As boomers give up on stock gains, they tend to focus on income investing, and are always on the hunt for higher yields. There is no secret to finding higher yielding securities. In one way or the other, a higher yield just means higher risk: either term risk, credit risk or price risk. Higher-yielding securities always have more risk than lower-yielding securities. And some high-yield securities can even be riskier than a simple basket of stocks, but with a lower expected return. For these reasons, you may want to ask your advisor to establish a sustainable withdrawal rate and build a diversified portfolio focusing on total return rather than focusing on dividend-producing, interest-paying securities.

Diversification does not ensure a profit or protect against a loss in a declining market. The opinions herein are those of Morningstar, Inc. and should not be viewed as investment advice.

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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