www.greshamcompany.com

Sticker Shock

by Stephen D. Gresham and Glen E. Gresham

My father and I had the same reaction when we looked at our copies of *The New York Times* on a Saturday morning at the end of January. On the front page, just above the fold, was an article entitled, “A Contrarian View: Save Less and Still Retire with Enough.” Had we read that headline correctly? After decades of helping retirees cope with financial and medical issues, our shock and dismay were the same as if a parenting magazine had declared “Let Kids Play in Traffic — It's Fun.”

The premise of the article was that the dire predictions that so many Americans are heading toward retirement disaster are way overblown. Most Americans are saving more than enough, the article says, and financial-services companies are playing Cassandras because it's in their self-interest — more saving means more assets and that means more fees.

While there are a number of things wrong with the arguments made in that article, I'll start with the big one: inflation. It may have been subdued during much of the bull-market period, but it's creeping back. And for someone who lives a long time, has a health crisis or just hasn't saved enough, even mild inflation has the potential to crush the retirement piggy bank. What's worse, price inflation is particularly pronounced on things that affect retirees most: housing and medical care.

Inflation is an economic cancer that may be treated but never really dies. And, like cancer, the threat of inflation is a factor neither expected nor planned for by most people until it strikes. But for those folks who have suffered from its impact, it is never forgotten and heartily feared.

Price inflation peaked at an annual rate in excess of 13.5 percent in 1980 — the first year of the Reagan presidency — a stunning rate by any measure. Mortgage rates and car loans issued at the time would be the envy of today's loan sharks. The burden of interest costs crushed the real estate market and the coincident national recession nearly drove Chrysler into bankruptcy.

Granted, we're not heading for 1980s-like price inflation by any account, but inflation seems to be heading higher. Core inflation grew 2.6 percent last year, up from 2.2 percent in 2005. And while energy and commodities prices have fallen back from their highs of the last two years, some economists predict that core inflation could climb as high as 3.5 percent in a year's time.

Even modest rates of inflation can have a debilitating effect on savings. The factors at work include the insidious effect of compounding — the reverse of that rule of 72 you've used to help focus clients on the rewards of investing. For example, suppose a retiree had a bundle of non-mortgage living expenses totaling $2,000 per month. At an inflation rate of about 3 percent, those expenses could be expected to climb to $2,060 next year. No big deal: We're talking about the cost of, say, two lattes a month. But time is sneaky and the compounding effect drives the number much higher over longer periods. In 10 years, the $2,000 cost is $2,688 — 34 percent more than today; in 20 years the same expenses are $3,612 — over 80 percent higher than the starting amount. Want more troubling numbers? Boost the inflation rate to 5 percent and our $2,000 today becomes $3,258 in 10 years and $5,307 in 20 years. Can your clients' investment portfolios handle that kind of sticker shock?

Economics 101 you say — everybody knows about inflation. Of course they do. “Everyone” also knows that they — or a spouse — could easily live to 90 and beyond and have factored that longevity into their planning, right? When my grandparents retired in 1972, their inflation “clock” started running. With some pension benefits, Social Security and investments, all four should have been in good shape — and they were compared to most people. But consider the impact of their longevity. One member of each household made it past 20 years in retirement — the longest, 34 years. The aging “winner” at 101 compounded her living expenses at 4 percent over that time and saw a $2,000 bill soar to nearly $8,000 per month. On an annual basis, $24,000 sounds tame; $96,000 does not.

AND THERE'S MORE

Most troubling is that some of the biggest costs that retirees face — housing expenses and health care — are rising fastest. Mortgage rates are rising, real estate taxes are going up — mine have doubled in the past eight years — and energy/heating/electric costs are soaring. While gas prices have fallen back a bit from their high of $3.13 a gallon in September 2005, they remain 50 percent higher than their constant dollar level prior to the Gulf War in 1990. Rising energy costs ripple through the economy. My electric company, for example, was just granted a 38 percent price increase and now my heating bill is twice what it was last year.

Meanwhile, medical care and insurance costs continue to escalate. According to data complied by the National Coalition on Health Care, elderly couples will need $200,000 to $300,000 in savings just to pay for the most basic medical coverage. Employer health care insurance premiums are still rising over double the rate of core inflation, or 7.7 percent in 2006. That's an improvement: Between 2000 and 2006, premiums were up 87 percent, compared to cumulative inflation over the period of 18 percent and cumulative wage growth of 20 percent. Driving that 87 percent increase are consumer demand, new treatments and more diagnostic testing (accounting for almost half); industry factors like higher technology costs, rising labor costs and the movement to broader access plans (almost a third); and general inflation (the rest). See any of those factors disappearing anytime soon?

Originally published in Registered Rep Magazine – March 2007 (www.registeredrep.com)

Stephen D. Gresham is executive vice president of Phoenix Investment Partners. His new book, *Advisor for Life*, will be released in Spring 2007 by John Wiley & Sons.

Glen E. Gresham, M.D., is professor emeritus of rehabilitation medicine at the University at Buffalo, The State University of New York.