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IMPACT OF INFLATION MUST BE CONSIDERED WHEN BUILDING FINANCIAL PLANS SAY TD ECONOMISTS

- Discussions about portfolio returns often overlook the loss of purchasing power due to inflation.
- The most relevant measure of inflation from a financial planning point of view is the year-over-year change in the Consumer Price Index (CPI), but since it does not reflect the specific outlays by individual households the CPI should be treated as only a rough guide to changes in the cost of living.
- Due to a change in the conduct of monetary policy, history is a poor guide for predicting inflation in the future. The double-digit and high single-digit inflation of the 1970s and 1980s is a thing of the past, as the Bank of Canada is likely to keep inflation within its one to three per cent target band in the years ahead.
- The low and more stable inflation environment has reduced the inflation premium provided by investments, thereby lowering unadjusted financial returns. However, it is after-inflation returns that matter. A lower return due purely to a lower rate of inflation leaves investors no worse off. Nevertheless, the reduced volatility of inflation may modestly dampen after-inflation returns, because investment returns are a reflection of risk, and risk is lower in a more stable price environment.
- This may give the misleading impression that low and stable inflation is bad for investors. Although inflation-adjusted returns may be modestly lower than in past decades, the subdued inflation backdrop will help to foster economic growth and prosperity, making for a superior investment climate.
- A well-diversified portfolio is expected to deliver an average annual total return of six to eight per cent over the next decade. On average, inflation will reduce the purchasing power of that return by two percentage points per year.

TORONTO – The impact of inflation needs to be considered when building financial plans and forming expectations about financial returns, said TD economists in a report entitled *The Corrosive Impact of Inflation on Financial Returns*. The report is available at www.td.com/economics.

“Most discussions about portfolio returns focus on the income flows and capital gains from investments without consideration of the loss of purchasing power due to inflation. But, this omission presents a distorted picture of the true financial performance,” said Craig Alexander, Vice President and Deputy Chief Economist at TD Bank Financial Group.

To illustrate, more than one-third of the average annual total returns provided by Canadian equities over the past three decades has been offset by inflation.

The corrosive impact of inflation on investment income is far from a new insight. Most books on personal finance contain some reference to the subject. However, there are three inflation-related issues that are often glossed over. First, amongst the various measures of inflation, which is the most appropriate to use when calculating after-inflation returns? Second, when building a financial plan, what is the best assumption about the future rate of inflation? Third, in light of this outlook for inflation, what are the implications for financial returns and portfolio decisions regarding asset allocation?

CPI is the traditional benchmark

“The most relevant measure of inflation from a financial planning point of view is the year-over-year change in the Consumer Price Index (CPI). In contrast to many other measures of prices, the CPI has the advantage of being restricted to the goods and services purchased by individuals,” remarked Alexander. However, the CPI will not reflect the outlays by any specific individual or household. For example, tobacco is a component of the CPI, but the majority of Canadians are non-smokers. As a result, the CPI should be viewed as only a rough guide to what is happening to the cost of living.

Inflation to average two per cent

“Although inflation has been low for more than a decade, the memory of the double-digit

and high single-digit inflation in the 1970s and 1980s lingers. However, there is good reason to believe that history will not repeat itself due to a change in the conduct of monetary policy by the Bank of Canada,” observed Alexander. During the 1990s the Bank of Canada introduced targets for keeping inflation in a range of one to three per cent, and since adopting this approach inflation has averaged 1.8 per cent. “Looking ahead, although inflation will fluctuate, there is every reason to believe that the Bank will keep inflation between one and three per cent, and average close to two per cent,” stated Alexander.

Low inflation environment has investment implications

The inflation outlook has a number of investment implications. It suggests that the unadjusted return on fixed income instruments will remain low by historical standards in the years ahead. Included in the yield on fixed income investments is a premium for the expected rate of inflation over the lifetime of the assets to compensate for the future loss of purchasing power, as well as a premium for the volatility and uncertainty about the future rate of inflation. As inflation has fallen over the past two decades, so too have the inflation premiums. “The bulk of the decline in long-term Government of Canada bond yields from an average of almost 12 per cent in the 1980s to below six per cent in the late 1990s is explained by lower inflation premiums,” remarked Alexander.

The low inflation environment will also constrain corporate profits growth, which, in turn, may affect equity prices. To illustrate, real GDP measures the increase in the volume of economic activity. When inflation is added, nominal GDP is an estimate of national income, which is divided between government, individuals and corporations – with the bulk of the latter representing profits. “In other words, profits are constrained by nominal GDP growth, which will be slower in a low inflation environment,” suggested Alexander.

It is after-inflation returns that matter

“At this point, some readers may have the impression that low inflation is undesirable. But, lower unadjusted returns are not the relevant benchmark. It is after-inflation returns that matter,” observed Alexander. To illustrate, investors should be indifferent between an investment paying six per cent when inflation is four per cent and an investment paying four per cent when inflation is two per cent, as the after-inflation return of two per cent is the same.

However, the sustained low inflation environment may constrain after-inflation returns due to a reduced premium related to lower volatility in inflation, but this impact is likely modest. And, as a partial offset, there is a tax advantage to the low inflation environment, since taxes are paid on the unadjusted income and capital gains.

“Moreover, while after-inflation returns may be slightly lower, the economy is clearly better off. Indeed, the economy is deeply and adversely affected when inflation is high and volatile, as it leads to the mispricing of real and financial assets and creates extreme volatility in interest rates. By creating a sustained subdued inflation backdrop, the Bank of Canada has engineered a low interest rate environment that helps to foster economic growth and engenders greater prosperity, all of which makes for a superior investment climate,” said Alexander.

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The Corrosive Impact of Inflation on Financial Returns (including charts and detailed tables), is available in PDF format on TD Economics' Home Page at

<http://www.td.com/economics>