Impact of Inflation

Canadian consumers are well aware of the impact of inflation on their household budgets. Every year it seems we pay more for utilities, groceries, school fees, entertainment and transportation. And if our paycheques aren't going up by at least as much, then we notice the pinch in our pocketbooks.

It's much the same when it comes to our investments. Inflation is defined as a general increase in prices, or a drop in the purchasing power of a dollar. As the prices of goods and services rise, the "real return" generated by an investment portfolio is less – that is, the return is worth less than it was before.

However, you may not have immediately noticed the impact on your portfolio. Let's say you invested in a balanced portfolio that returned 7% last year. Your investment statement reflected that gain, so the value of your investment portfolio went up – and was reflected on the bottom line. But if inflation was 2% – the average rate in Canada over the past 20 years[1] – the purchasing power of that portfolio fell by that amount, and therefore the real return was only 5%. If the portfolio had a negative year, the loss would then be greater than the nominal amount as inflation was still 2%.

As you can see, over time, inflation can significantly erode a portfolio's returns, especially if markets have been volatile.

Canadians who have retired or are about to retire may have even more reason to be concerned about the impact of inflation on their portfolios. When you are a retiree, you no longer have a salary that can increase every year, and you are dependent on the nest egg you have built. If prices go up, but the return from your assets doesn't, then you may find you are unable to meet your spending needs.

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While inflation has been relatively benign in recent years, any Canadian who invested or borrowed money during the 1970s has a good idea of the dramatic impact a sustained increase in prices can have. Inflation rose to more than 14% in 1973 and almost 13% in 1979 before tight monetary policies wrestled it down to between 4-6% in the 1980s and then stabilized it at around 2% annually since 1992[1]. While you may have earned double-digit returns on certain savings vehicles — such as Guaranteed Investment Certificates — in the late 1970s, your mortgage would have been negotiated at around 12-13%, and the interest rate on personal loans could have reached more than 18%. So even though inflation was beginning to subside, you were stuck paying those high rates for years to come.

This period of high inflation was partially sparked by U.S. President Richard Nixon's decision to abandon the gold standard. Holders of U.S. dollars were no longer able to trade these currency holdings for a fixed amount of gold. That meant there was no limit to the amount of U.S. dollars that could be created. This reverberated through the countries, like Canada, with strong ties to the U.S. dollar. The oil price shocks in that decade and accommodative monetary policies domestically were additional factors.

Some observers are concerned that the huge increase in global money supply over the past few years to counteract the recessionary impact of the 2008–2009 credit crisis could lead to a potential inflationary shock in the future.

How can Canadian investors protect themselves against the impact of inflation?

Add potential inflation hedges to your portfolios that may include:

› **Inflation-linked bonds:** The principal and each coupon is indexed to the inflation rate, to compensate the investor for the loss of purchasing power.

› **Real Assets:** These include listed infrastructure and real estate investments. These types of investments generally have stable income streams (from rent or concessions) that are usually tied to the Consumer Price Index (CPI).

› **Gold:** The traditional hedge against inflation, gold prices usually go up when the purchasing power of the U.S. dollar decreases.

Invest in a multi-asset strategy

These strategies generally target CPI + 3-5% return and can invest in a variety of assets that can include equities, bonds and alternative investments across a range of styles and geographies. They are highly reliant on a portfolio manager's skills but can hold the potential for returns above the rate of inflation with lower volatility at the total portfolio level.

For more information on how Russell Investments can help you pursue your investment goals, please ask your advisor or contact us at 1-888-509-1792 or visit us at russellinvestments.com/ca

[1]Bank of Canada website, http://www.bankofcanada.ca/publications/books-and-monographs/why-monetary-policy-matters/2-inflation/

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