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Right-Sizing Inflation Concerns Among Pre-Retirees

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Introduction

This essay addresses two questions:

How well-founded is the recent increase in concern about inflation in retirement among American pre-retirees (those who may retire soon)?

What steps are appropriate for pre-retirees in response to high-inflation periods and to address concerns about inflation more generally?

To answer, the essay investigates the sources of income retirees will receive and the types of expenses they can expect to incur. There is no universal answer to how concerned pre-retirees should be about inflation, but rather various factors that affect the extent of appropriate concern for each individual. Following exploration of these factors, a general prognosis and recommendations will be provided.

Level of Concern

Inflation has become a focal point of individuals' financial worries over the past year. In April 2022, an annual Gallup survey asked Americans,[1] "What is the most important financial problem facing your family today?" The most common response by far (32%) was "high cost of living/inflation", with those closer to retirement age more concerned about inflation than younger age groups. For comparison, in the five prior years, inflation was the answer for under 10% of participants.

In a separate Gallup poll taken in April 2022, 63% of Americans responded that they are very worried or moderately worried about having enough money in retirement, up 7 percentage points from 2019 (both pre-pandemic and before high inflation).[2]

[1] https://news.gallup.com/poll/392162/personal-finance-ratings-slide-amid-rising-prices.aspx

[2] Note that in April 2022 the S&P 500 was down less than 10% from its January 2022 high, and still up 50% from April 2019, so any increased worry would seem more likely to be from higher inflation rather than decreased assets. https://news.gallup.com/poll/392432/americans-financial-worries-tick-past-year.aspx

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In an FGLife survey conducted in May 2022[3], 80% of Americans age 50+ stated that they are worried about inflation in retirement (up 7 percentage points from the prior year), with pre-retirees (84%) more concerned than retirees (76%).

Effect of Inflation on Retirement Income Sources

The first income source to explore is Social Security, due to its high usage and inflation-indexing. Social Security retirement benefits will increase 8.7% in 2023 following a 5.9% increase in 2022. Over a quarter of 65+ retirees receive at least 90% of their income from Social Security, a third receive at least 75%, and a little over half (53%) receive at least 50%[4]. Evidently, many Americans heavily rely on Social Security, and for them the inflation protection is quite substantive. Concerns about the longevity of Social Security and the feasibility of inflation-linked benefits continuing indefinitely may counteract this reassurance about inflation protection. Exploring those concerns is beyond the scope of this essay but is a valuable topic for further research.

Beyond Social Security, in 2014 (the latest data available from the SSA) the income of those 65 or older broke down as follows[5]:

- about 15% received a government employee pension, which typically include cost-of-living adjustments (COLAs)
- almost 40% received a private pension or annuity, which usually do not contain COLAs
- 60% received income from assets, which has the potential for inflation protection

While the comparison during retirement is straightforward (COLA is preferable to no COLA), the pre-retirement period is more complicated: how the benefit is determined will dictate how exposed a participant is to inflation. Considering the private sector, while only 14% of Fortune 500 employers offered defined benefit plans to new hires in 2014, almost half (46%) of these companies employed workers who actively accrued benefits[6]. Frozen benefits are eroded by inflation over time, but for those accruing, most companies have a formula that helps offset effects of inflation.

Among defined benefit plan sponsors, 71% offered a cash balance plan, and 18% offered a traditional final average pay plan. The cash balance plan should offset inflation with higher returns during times of higher inflation. The final average pay plan protects participants against inflation to the extent their wages increase along with inflation, unlike a career average pay plan where higher wages a few years before retirement has a minimal offsetting effect due to many years of lower wages.

Like the longevity of Social Security, wages keeping up with inflation is an important caveat both for final average pay plans and for workers to be able to save sufficiently for retirement expenses when reliant on defined contribution plans. Given the importance of the issue, further research and exploration of this link and its effects on workers' ability to retire would be useful. The extent to which inflation might outpace wages would also be relevant

[3] https://www.fglife.com/news/retirement-survey-2022.html
[4] https://www.ssa.gov/policy/docs/workingpapers/wp116.html
[5] https://www.ssa.gov/policy/docs/statcomps/income_pop55/2014/sect02.pdf
[6] https://www.wtwco.com/en-US/Insights/2020/06/retirement-offerings-in-the-fortune-500-1998-2019

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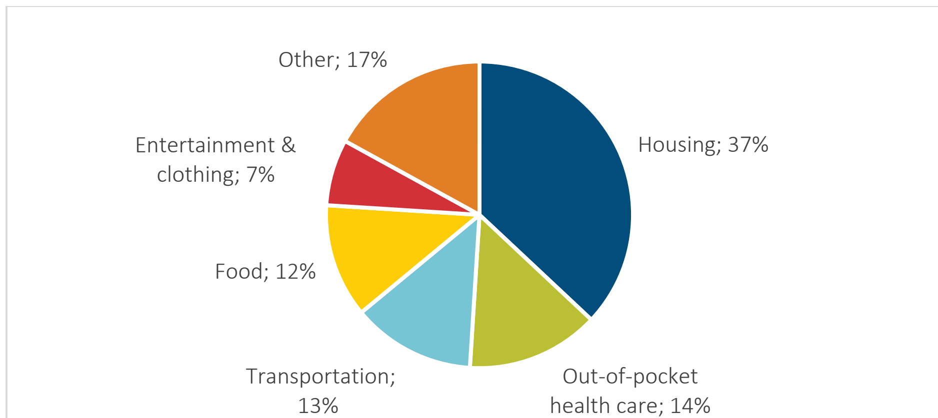
to incorporate in research on the future of Social Security, as outflows from the program would grow faster than inflows.

Finally, considering income from assets, a classic 60/40 stock/bond split, for example, is somewhat vulnerable to inflation: the only negative 10-year real returns for this portfolio from 1900 to 2015 have occurred when inflation was over 5%. One explanation for the poor returns during high inflation is that investors "avoid being tied to fixed-income payments when interest rates [are] rising…But they also [demand] a bigger discount rate on equities, so both asset classes [decline]."[7]

Effect of Inflation on Retirement Expenses

Moving to retirement expenses that income needs to cover, Figure 1 shows the mean distribution of expenses for those over age 65.

Figure 1
MEAN PERCENTAGE PERSONS OVER 65 ALLOCATE TO COMPONENTS OF TOTAL EXPENDITURES[8]



For housing, in terms of ongoing costs, 55% of persons 65 or older own with no mortgage, 25% have a mortgage, and 20% are renters. The mean percentage allocated to housing expenditures follows intuitively: about a third of expenses are allocated to housing for those without a mortgage, about 40% for those who have a mortgage, and almost half for those who rent. Considering the effects of inflation on these groups:

Owners with no mortgage are relatively sheltered from housing inflation, although rising property taxes and insurance premiums could pose a burden.

Mortgage holders are mostly protected as their loan repayments are static regardless of the housing market rapidly inflating.

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[7] https://www.alliancebernstein.com/sites/library/Instrumentation/DCI-7213-0615.pdf
[8] https://www.ssa.gov/policy/docs/chartbooks/expenditures_aged/2020/exp-aged-2020.pdf

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Renters are the most exposed to housing inflation. While the available SSA data does not crystallize the link, most retired renters likely receive much of their income from Social Security, so while their rents might rise rapidly, hopefully their income would rise to offset this increase.

Health care expenses have a combination of inflationary effects on retirees: medical costs continue to rise faster than broader inflation and retirees have increasing medical care needs as they age, giving this inflation time to compound. Specifically, the SSA expenditure data shows that for 55- to 64-year-olds, the median allocation of their spending to out-of-pocket health care costs is 7%, while it jumps to 13% for 65- to 74-year-olds and to 16% for those 75 or older. Even if a retiree's income is entirely inflation protected (e.g., 100% of income is from Social Security), assuming they retired and began benefits 10 years ago at age 65, their income will have increased by only 28% while medical costs will have increased 33%[9] from inflation alone (i.e., not considering increased costs associated with aging).

For transportation, the CPI for Transportation has roughly tracked inflation in the economy[10], although with a little more volatility. Fortunately, transportation expenditures tend to decrease as retirement progresses: the median allocation to transportation is 12% for the age group 55- 64, 10% for those 65-74, and 6% for those 75 or older. As a result, inflation in this category primarily affects expenditures in the first few years of retirement, so there is minimal compounding effect.

Prognosis and Recommendations

The simplest conception of the prognosis and therefore recommendation for soon-to-be retirees regarding inflation in retirement is that they *should not be overly concerned, but should be aware and take prudent, non-drastic steps to address the risk*.

First, the largest step one could take in response to inflation concerns: delaying retirement by continuing to work longer. A 2020 NBER paper[11] found that the financial effect of eliminating a 3% COLA in a pension plan is offset by the participant delaying retirement by 4.5 months and for a 5% COLA working 7 months would offset the lost benefit. For comparison, the worst 30-year period of inflation in the United States was 5.40% (from 1965-95 and 1966-96), so even if all a retiree's income would be from sources not linked to inflation, they would only need to work part of a year to offset the effect of the worst retirement-length inflation the US has experienced. Certainly, a pre-retiree may want to continue working full-time longer or shift to part-time before fully retiring for asset accumulation and cash flow reasons generally, but *delaying retirement for long primarily due to inflation risk is not necessary for potential retirees.*

Second, those considering retirement can take an inflation-protecting step without continuing to work by *delaying beginning Social Security payments*. Given that many retirees receive much of their income from Social Security, this is potentially a highly impactful strategy. Some strategies to use savings to delay Social Security benefits include higher initial withdrawals from 401(k) accounts or IRAs, early commencement of pension benefits, and reverse

[9] This comparison uses the CPI-W and CPI for Medical Care increases over the last 10 years.
[10] Consumer Price Index for All Urban Consumers: Transportation in U.S. City Average vs Consumer Price Index for All Urban Consumers: All Items in U.S. City Average
[11] https://www.nber.org/sites/default/files/2020-11/NB20-13%20Fitzpatrick%2C%20Goda.pdf

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mortgages. A 2017 study[12] from the Stanford Center on Longevity found that "using savings to enable delaying Social Security benefits increases total retirement incomes (including Social Security) for the test cases in this study by amounts ranging from [3% to 18%]." As the authors state, "Social Security's current delayed retirement credits were designed when interest rates were higher and life expectancies were shorter, compared to today. In addition, Social Security added an automatic adjustment of benefits to address inflation. The adjustment factors for delayed retirement would be less generous if they reflected these two factors." These factors mean that retirees can generally increase their Social Security benefit by more than the amount that it is costing them in lost payments and not only protect themselves well against inflation but also increase their expected retirement income in the process.[13]

Third, to the extent possible, *a pre-retiree should fund a Health Savings Account and use it for medical expenses in retirement as needed*[14]. The tax benefits of an HSA and its investment earnings can partly offset growth in health care costs.

Fourth, pre-retirees and retirees expecting significant income from assets should *invest some assets in classes that perform well in times of higher inflation*. These include I Bonds, TIPS, REITs, and commodity stocks. From 1990 to mid-2014, the average annualized performance for a 1% rise in inflation for various asset classes was: -0.2% for a 60-40 stocks/bonds portfolio, 1.1% for TIPS, 4.8% for REITS, and 6.7% for commodity stocks.[15] TIPS match inflation almost exactly, but given that many investors choose to seek a higher return so will not only hold TIPS, it is relevant that TIPS do not offset stock and bond downturns, whereas other asset classes can because they "either cause the inflation (like certain commodities) or they're quickly able to pass through rises in inflation by hiking rent prices (like real estate)."[16]

[12] https://longevity.stanford.edu/wp-content/uploads/2017/11/Optimizing-Retirement-Income-Solutions-November-2017-SCL-Version.pdf
[13] In some situations, delaying may not be optimal. The SSA calculator can help with modeling different scenarios.
[14] From a tax-minimizing standpoint, it is preferable to drawdown from taxable or tax-deferred accounts (like 401(k)s) before pulling any money from HSAs. Due to HSAs not taxing withdrawals if used for medical purposes, allowing further asset growth within HSAs is preferable. Receipts from medical expenses can be saved for later reimbursement.
[15] https://www.alliancebernstein.com/sites/library/Instrumentation/DCI-7213-0615.pdf
[16] https://www.alliancebernstein.com/sites/library/Instrumentation/DCI-7213-0615.pdf

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Conclusion

The effect of inflation on any individual's retirement will depend partly on specific sources of income and types of expenditures. For most Americans, inflation does not pose an extreme concern but rather one that should be addressed with relatively minor careful changes. Table 1 provides a guide to summarize how major items in an individual's situation lead to varying levels of inflation protection or exposure.

Table 1

INFLATION IMPACT OF TYPICAL ATTRIBUTES OF RETIREES' FINANCES

Note: the number of arrows in each direction indicates the level of impact. For example, 3 up arrows indicates that a retiree has a much-increased ability to withstand high inflation, while 2 down arrows would be a moderately decreased ability.

Projected Attribute	Effect on Retiree's Ability to Withstand High Inflation	Rationale
High percentage of retirement income from Social Security	↑↑↑	Much of the retiree's income increases along with CPI-W
Own a home (with or without a mortgage)	↑↑	Housing costs are mostly static; potential increases are taxes and insurance premiums, which are small relative to rent
High expected health care expenses (e.g., expensive health condition at retirement)	↓	Health care costs have increased faster than general inflation, so if this continues a high need for medical services might result in spending outpacing income increases
High percentage of non-SS retirement income from a non-COLA pension that accrued until retirement*	↓	Part of income does not increase with inflation at all; effect depends in part on how large pension is relative to Social Security
High percentage of non-SS retirement income from a non-COLA pension that stopped accruing long before retirement	↓↓	Like the accruing-until-retirement pension, but inflation eroded the pension before retirement even began, leading to lower initial replacement ratio and loss of purchasing power in retirement
High percentage of non-SS retirement income from invested assets	↑	Depends on how assets are invested, but unless the sole investment goal is inflation protection, there will be some vulnerability to inflation

*Assuming the plan is Final Average Pay or Cash Balance. For a long service participant, a Career Average Pay formula with high inflation occurring immediately before retirement would be more like the pension that stopped accruing.

Typically, a potential retiree will have some projected attributes with positive effects on their ability to withstand inflation and others with negative effects. Pre-retirees should consider whether the effects generally offset or are mostly unidirectional. For example, were a retiree to have most of their retirement income from a non-COLA pension that has been frozen for many years and they did not own a home but rather rented, this would be a relatively concerning situation for inflation effects and call for some protectionary changes. Conversely, owning a home and most retirement income coming from Social Security would be a comfortable situation inflation-wise and

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require few changes. Each person approaching retirement or in retirement should similarly gauge their own exposure to inflation, by considering their sources of income and distribution of expenses, and then determine how they should act to mitigate their personal level of inflation risk. Delaying retirement long is likely unnecessary, delaying Social Security is typically prudent, funding an HSA can help with increased medical costs, and investing in inflation-responsive assets can help income from assets rise with prices.

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