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July 2021 Crescent Commentary

In this month's Commentary, we'll discuss one of the great long-term destroyers of your irreplaceable wealth, and what we do to limit its impact on your lifestyle. When most investors think about risks to their retirement plan, the three C's often come to mind: corrections, crashes, and crises. Yet for investors properly advised and allocated, the three C's will not harm your retirement. U.S. stocks have increased at an annual rate of more than 7% a year since the year 1900, despite a continuous stream of unprecedented corrections, crashes, and crises. Only those investors who sell during those events experience the negative effects. Last year was the most recent example of this(1).

The destroyer of long-term wealth that we'll discuss in this commentary is a silent killer. It will permanently erode your wealth regardless of how you're invested. The best anyone can do is limit its impact, but not eliminate it. No one ever seems to ask us about it or mention it. Why? Probably because it's been more than forty years since it led to sensational headlines. Yet every month, our government reports inflation figures that tell you exactly how much your standard of living has permanently fallen over the past year. We mentioned inflation in a Commentary earlier this year, but given its recent acceleration, we want to describe its impact on your wealth in more detail, and discuss what we do to protect your wealth from its effects.

The U.S. government provides inflation data going back 118 years to 1913. When looking at a metric like inflation, which varies substantially over time, it's important to use long-term averages – the experience of the past ten or twenty years may in no way resemble the experience of the next ten or twenty years. What has been the impact of inflation over time? One dollar in 1913 now equals $26.69 in 2021. That comes out to an annual inflation rate of about 3%. That means U.S. citizens have permanently lost roughly 3% of their wealth and spending power on average every year. An annual inflation rate of 3% means your wealth essentially gets cut in half every twenty-five years. So, living off of $10 million today is like living off of $5 million in the future. This poses a major problem for investors who want to maintain a certain lifestyle in retirement. Obviously, no one wants their money to go half as far in the future. In order to prevent that from happening, investors need to allocate their wealth to assets with a history of generating average annual returns that make up for the loss to inflation(2).

Of course, the challenge of overcoming inflation increases as the inflation rate increases. The U.S. has recently seen an acceleration in inflation, with a 5.4% increase in consumer prices reported for the month of June. Although economists debate how long inflation will remain elevated going forward, all Americans have experienced a permanent reduction in their standard of living as a result of June's large increase in prices[3].

So how do we protect our clients' irreplaceable wealth from permanent loss to inflation? Your parents and grandparents could rely on simple rules of thumb to determine how to allocate their retirement assets: one hundred minus your age – equals the percentage of stocks you should own. And the rest goes into bonds. Well, the world has changed dramatically. In 1981, the 10-year U.S. Treasury Bond yielded 13.9%. In 1991, 7.9%. In 2001, 5.0%. Today? 1.2%. The broadest index of bonds in the U.S. is the Barclays Aggregate Index. It currently yields 1.3%. So retirees maintaining a 1980s or 1990s bond allocation permanently and continuously lose a portion of their irreplaceable wealth due to bond yields that are substantially lower than the inflation rate[3][4].

As a result of the failure of bonds to protect investors' irreplaceable wealth from inflation loss, our Group allocates a higher portion of client assets to stocks / equities than we would have thirty years ago. Stocks have a long-term, demonstrated track record of generating returns in excess of inflation. As we mentioned at the beginning of this commentary, U.S. stocks have generated an average annual return of roughly 7% a year over the past 121 years. This 7% return exceeds average inflation and also covers living expense withdrawals[1].

Of course, not all investors who invest in stocks enjoy the full 7% annual return that stocks have generated over the long term. The main culprit is emotions. A recent study by DALBAR showed that over the past twenty years, investors in a balanced allocation of 60% stocks and 40% bonds earned a 2.6% annual return, compared to the 6.8% return that they would have earned if they had simply ignored their investments and not touched them. Why did the investors earn almost two-thirds less than they should have? Fear and exuberance. There's nothing harder than sticking with an investment strategy when markets are crashing. And second to that is sticking with a proven investment strategy when people treat the stock market like a casino and there's an urge to get in on the action. The average investor sold when markets crashed and threw money at what was popular during periods of exuberance, and it has had a detrimental impact on their irreplaceable wealth[5].

Our Group understands the emotions involved with investing, and we work hard to help our clients stick with the proven long-term investment process that we have established for them, both in despondent times and in euphoric times. Doing so helps insure that our clients earn the full return they need to protect their irreplaceable wealth from permanent loss to inflation, so that they can maintain the lifestyle they want and need now and in the future.

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Sources:

(1) S&P Dow Jones Indices LLC
(2) Bureau of Labor Statistics
(3) The Wall Street Journal
(4) The Board of Governors of the Federal Reserve System
(5) RBC Wealth Management