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Retirees: Inflation Protection for Retirement Portfolios

Retirees and pre-retirees have been challenged by the investing environment during the past few years. As it becomes harder to generate a livable income stream from retirement portfolios given the low bond yields, retirees have to choose between tapping their principal and venturing into high-yielding, but also riskier, securities. Inventors are concerned about what could happen to their bond portfolios if interest rates were to rise. While inflation currently appears to be in line with historical norms, retirees remain concerned about the potential for rising inflation and its effect on their portfolios. Inflation-linked securities like Treasury Inflation-Protected Securities (TIPS) are the most direct way to hedge against inflation. But even investors who are convinced that TIPS are a good place to be still have questions about implementation.

Here is why inflation protection is important for retirement portfolios. Retirees miss out on some of the inflation protection that working people normally enjoy. Paychecks will generally trend upward to keep pace with rising prices but retirees don't have that safety net. Social Security payments are adjusted upward in an effort to keep pace with rising prices. But to the extent that a retiree is living off a portfolio anchored in fixed-rate investments, the payout from that sleeve of the portfolio will be fixed. If prices go up, the purchasing power of that portfolio, and in turn the retiree's standard of living, goes down. This is why inflation-indexed securities like TIPS, whose principal values adjust upward to keep pace with inflation, are an important part of a retiree's fixed-income portfolio.

TIPS are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. TIPS are subject to unique risks, most notably liquidity risk and inflation risk.

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Six Reasons Why Boomers' Retirement Is Different From Their Parents'

1. Much Longer Retirement: Many people in previous generations worked as long as they could and very few were fortunate enough to have a retirement that would be considered "golden" by today's standards. How many spent the last third (or more) of their lives pursuing hobbies and leisure instead of working? Boomers retiring in their 60s can expect to live about 30 years in retirement, which is a lot longer than their parents did.

2. Higher Expectations: Not considering tours of duty in Europe or the Pacific, how much traveling did past generations of retirees do? Boomers' parents were Depression-era babies who practiced frugality and continued to pinch pennies throughout retirement. In stark contrast, boomers want their retirement to include travel, vacation homes, new cars, dining out, etc. This is fine, but it is expensive. Therefore, boomers need to plan for a much more expensive retirement than their parents ever would have expected.

3. Personal Savings Instead of Pensions: The greatest generation might have had a lower per capita income but many also had corporate pensions. Boomers wanted higher salaries, freedom to change employers and the ability to save independently. Corporate pensions were largely phased out, giving way to the 401(k). However, when given the option, most boomers didn't start saving enough or early enough. Today, many boomers haven't amassed enough in personal savings, and most don't have meaningful pensions compared to their parents.

4. Rising Instead of Declining Interest Rates: In the 1980s, when the greatest generation started to retire, interest rates were much higher than they are today. The long decline in interest rates provided a great return to bond investors. The boomers are facing the very opposite situation. Instead of an ever-declining interest rate, they are facing the likelihood of steadily increasing interest rates during their retirement.

5. Exotic Investment Options: The greatest generation had relatively few investment options; mostly ordinary bonds and certificates of deposit. Today's boomers, on the other hand, are being offered an ever-expanding universe of income securities. The investment industry has provided a lot of rope, and a lot of new and exciting ways to lose it all.

6. Deregulations: If they felt like taking risk, the boomers' parents might buy some dividend-paying stocks. At the time, most of the dividend-paying industries, such as finance and utilities, were highly regulated. Decades of deregulation have caused these industries to become less predictable and more risky; hence, the certainty of previously assumed dividends is now extremely uncertain.

What Boomers Really Need: As boomers give up on stock gains, they tend to focus on income investing, and are always on the hunt for higher yields. There is no secret to finding higher yielding securities. In one way or the other, a higher yield just means higher risk: either term risk, credit risk or price risk. Higher-yielding securities always have more risk than lower-yielding securities. And some high-yield securities can even be riskier than a simple basket of stocks, but with a lower expected return. For these reasons, you may want to ask your advisor to establish a sustainable withdrawal rate and build a diversified portfolio focusing on total return rather than focusing on dividend-producing, interest-paying securities.

Diversification does not ensure a profit or protect against a loss in a declining market. The opinions herein are those of Morningstar, Inc. and should not be viewed as investment advice.

Creating a Budget

Creating a budget may seem like a complicated and unnecessary burden for most people, but a budget can be a valuable tool for managing your money. Instead of thinking about it as just another tedious thing to do, think about how a carefully-constructed budget can help you reduce expenses and optimize the way you spend.

Why do you need a budget? First of all, income does not always equal expenses. A budget is a resource-management tool that can help you achieve your long-term financial objectives, for example, saving more in order to meet retirement goals, freeing up monthly cash flow in order to pay down debt, or simply reducing expenses. Think about the budget simply as a plan for what you're going to do with your money. Here are a few guidelines to help you get started.

1. Track your income and expenses. In order to begin building a realistic budget, you'll need to track your revenue and expenses for at least a month or two. Start by writing out any sums of money that you receive and spend. If you have multiple sources of income, make sure to take all of them into account. For expenses, it may help to list them in order of magnitude. You can even create various categories if it helps you stay organized. The largest expense is probably your mortgage or rent. Then you have utilities (water, heat, electricity), auto expenses (car payment, insurance, gas, maintenance), food, medical/dental expenses (insurance, prescriptions), and so on. The important thing here is not to forget the little expenses. For example, if you go out for lunch, buy a magazine to read on the train, or go out for coffee with your coworkers, these expenses, however insignificant they may seem, need to be included in your budget. They say a small leak can sink a great ship; similarly, a few dollars here and there can add up faster than you think.

2. Start planning ahead. Once you have tracked your income and expenses for awhile, you should have a pretty good idea of where your money comes from and where it goes on a monthly basis. However, some expenses do not happen regularly, and you still need to be prepared for these eventualities. If you anticipate these expenses and include them in your budget, you can plan accordingly without breaking the bank. Some examples of such overlooked expenses are holiday gifts, emergency car repairs, and travel or vacations.

Now you are ready to create your budget. Based on the income and expenses you tracked during the past few months, write down what you expect your income and expenses to be next month, or for the next few months. Try to be as realistic as possible; your budget should reflect your actual financial situation, not your ideal one.

3. Stick to your budget. Creating your budget will be easy compared with sticking to it. It's not a disaster if you spend a few extra dollars here and there, but in next month's budget you should account for them. The budget is a plan, an estimate, but it is in your interest to keep this estimate as accurate as possible. Also, if you notice unusually large expenses where there shouldn't be any, now is the time to adjust them. Keep in mind that your budget should change as your financial situation changes, so monitor it regularly and make changes when necessary.

Eventually, a budget is supposed to teach financial discipline and the difference between necessity and luxury. You may be surprised to find out how much money flies out of your pocket for things you don't need and therefore will not use. It may seem that sticking to your budget means making many sacrifices, but ultimately it's your financial future that you're building.

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

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