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Private Wealth

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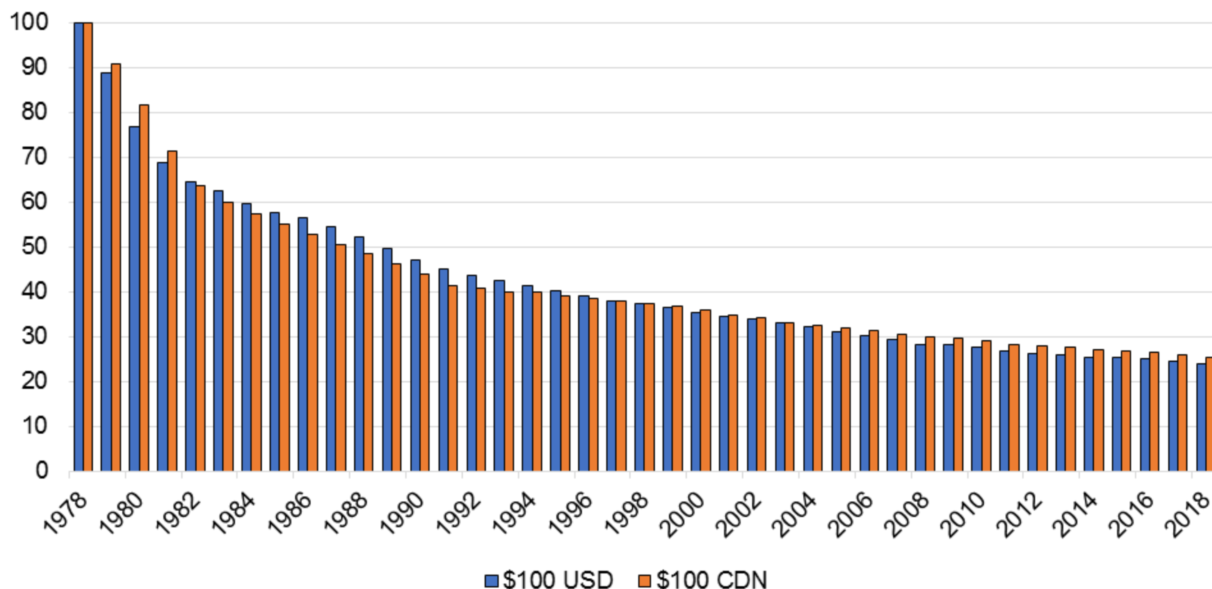
QPW Perspectives – September / October 2019

Why do we save money? We save money because it is a store of future consumption, whether that be for a major purchase (house, car, etc.), retirement, education, or anything else we may decide to purchase in the future. Therefore, it is important to understand the factors that can impact your level of future consumption – two of the most significant being inflation and taxation. In this newsletter, we are going to focus on inflation in the context of portfolio management.

The late economist Milton Friedman said that "Inflation is taxation without legislation." Inflation is something we have all come to accept as part of our daily lives, but its effects on our finances over the long-term are usually not well understood. Inflation acts as a tax because it diminishes the purchasing power of our money. From a financial perspective, this affects our ability to save because it increases our cost of living. More importantly, it can skew how we view the "value" of our investments in light of our long term financial objectives.

While inflation in North America is comparatively low and certainly less prevalent than in some emerging market countries, its effects on purchasing power over long time periods is undeniable. For example, the following graph depicts the purchasing power of $100 (both Canadian and U.S.) from 1978 to 2018. In both cases, purchasing power has been eroded by approximately 75% over the period. In other words, the average cost of consumable goods and services has increased by approximately 300% since 1978 ($20 worth of groceries in 1978 would cost about $80 today).

Value of $100 U.S. and Canadian in Real Terms: 1978 - 2018



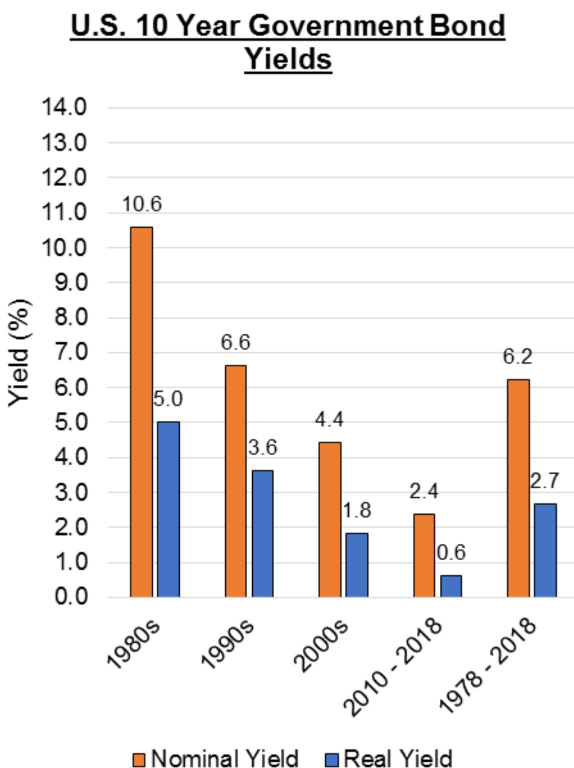
Note: "Real" in the context of finance means adjusted for inflation (nominal – inflation = real).

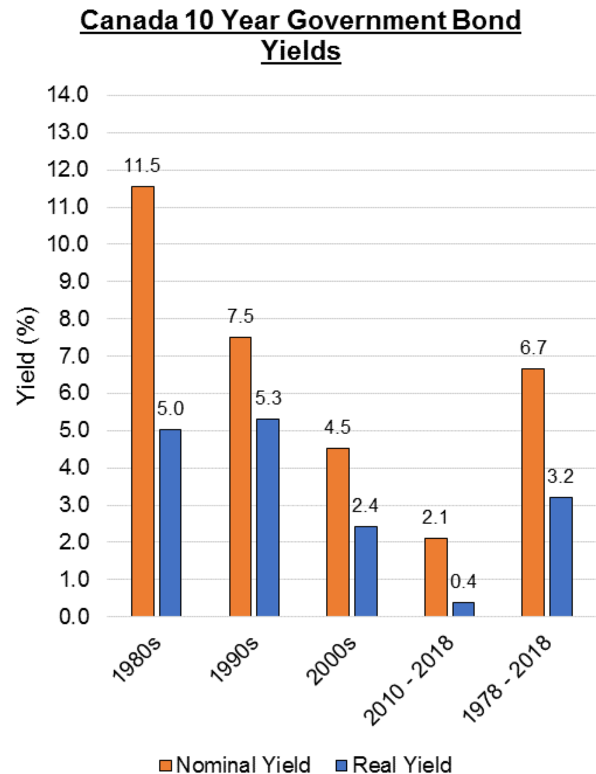
While we discuss inflation as something real and tangible, it is more abstract in reality. Inflation is defined as a sustained increase in the general price level of goods and services over time. In Canada, the common measure used to track inflation is the Consumer Price Index (CPI), which is calculated based on a broad "basket" of approximately 600 goods and services. This CPI basket is meant to be reflective of the average assortment of consumable goods and services purchased by households.

However, while this tracks an average inflation rate across the country, it may not reflect your own personal inflation rate. This is because variations based on your age, family, lifestyle and city where you live in can materially affect your cost of living. For example, a retired couple living in downtown Toronto will have a different basket of goods and services than a young family living in rural Manitoba. Not only will the baskets vary, but so will the costs of those goods and services.

When it comes to our routine expenditures, we "feel" the impact of rising prices (and taxes) on our purchasing power. However, when it comes to our savings we tend to think in nominal terms without considering the impact of inflation.

Understanding inflation's impact on a portfolio goes beyond examining the real rate of return versus the nominal return. Certain investments tend to perform better than others in inflationary versus deflationary environments. The bond market (and GIC market) is very much tied to the rate of inflation. Investors who buy bonds want to be compensated for inflation since they will be paid a fixed amount of money over the life of their bonds. In other words, they want to ensure they're being compensated for the decline in their purchasing power. Therefore, as inflation increases, so does the market required yield on bonds, which drives down bond prices. Historically, the real yield on bonds has varied quite a lot, even though they are viewed as safe or low risk investments. The charts below show how nominal and real yields for Canadian and U.S. government bonds have fluctuated over different time periods. The important take away from this is to remember that what we can expect to earn, in real terms, will vary even with safer investments like government bonds.





Source: Bloomberg

Stocks, unlike bonds, can be expected to go up in value in inflationary environments. However, this depends on how high the inflation rate is and its persistence. Lower inflation rates typically allow businesses to pass on cost increases to consumers. Therefore, as inflation increases, so do the nominal profits of most businesses. Significant and pervasive inflation is usually the symptom of structural economic problems and/or imprudent government or monetary policy. In these cases companies may not be able to pass on all of their costs to consumers and may experience declining profit margins.

Real estate and certain commodities are also viewed as inflation "hedges" because they tend to increase in value when the general price level goes up. The relationship between stock prices, commodities and inflation is not one-to-one however. Stock and commodity prices are far more volatile than inflation because they involve speculation over growth, supply and demand. Canadian inflation, because it includes a large and diversified basket of goods and services, has historically increased at a steady pace of around 2% per annum in recent decades.

Your investment portfolio must, at a minimum, achieve investment results that maintain buying power. This minimum acceptable return requires some acceptance of risk in your portfolio, which in turn, is reflected by the asset classes and asset mix that make up the portfolio. Ultimately, in building and monitoring a portfolio, as it relates to inflation, it is important to consider two factors:

1. How has my portfolio fared versus inflation rates?
2. How will the building blocks of asset classes in my portfolio react in inflationary and deflationary environments?

A typical portfolio will have stocks, bonds and real estate and each will be affected by inflation in different ways. Proper portfolio construction should have an allocation to asset classes which protect capital from purchasing power erosion over the long term. The best way to achieve this is to have a meaningful exposure to stocks and real estate. These two asset classes have shown to have the highest correlation with inflation over long time periods. We typically advocate holding a diversified mix of Canadian, U.S. and international stocks as well as an allocation to real estate.

Over the long term, inflation will negatively impact the purchasing power of your savings. Your portfolio design needs to account for this impact (among many other factors). This is why Quadrant Private Wealth integrates rigorous wealth planning that is specific to each client's circumstances into our portfolio management process.

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Quadrant Private Wealth is an independent, comprehensive, integrated wealth management firm committed to your financial well-being and peace of mind. We take the time to understand your complete financial picture. We tie all of your information together, including tax planning, to paint a picture of what your financial future could look like. And we aim to earn your complete confidence in the process.

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All returns and figures sourced from Bloomberg.

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