Investing Essentials:

Deflating inflation worries

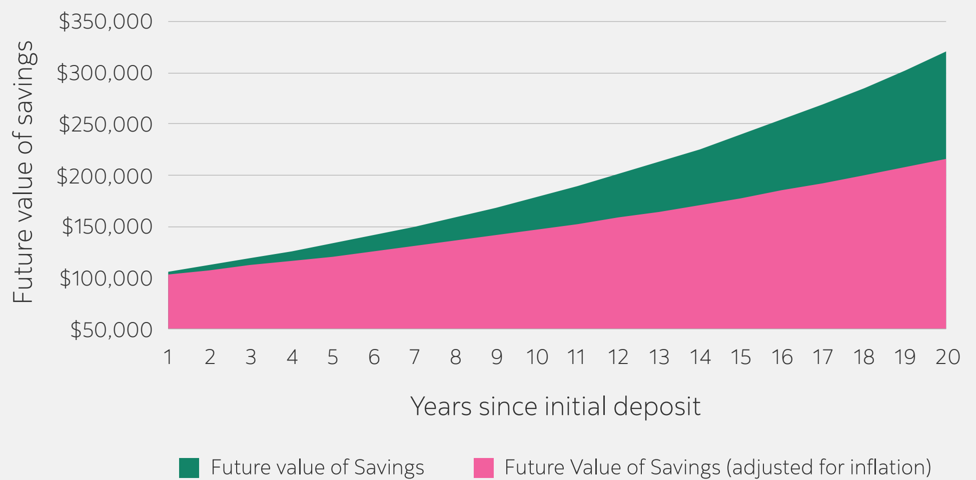
As you map your investment journey, inflation may not always be top of mind. Often taking a backseat to market risk, inflation can pose a very real threat to your investment goals by lowering returns and eroding the purchasing power of your savings. In this article, we look at the impact of inflation on investment returns and provide some actionable strategies to help position you for long-term success.

Impact of inflation

While a certain amount of inflation is necessary to sustain a healthy economy, persistently high inflation can hurt both savers and retirees. Investors who earn less than the rate of inflation on their investments over the long run have reduced purchasing power when their investments are converted back to cash. This is especially troublesome for investors who are living on a fixed income or need their accumulated savings to generate regular income for several decades. The following examples highlight how savers and retirees both need to be mindful of inflation.

Saving years:

Ruby is 40 years old with a portfolio valued at $100,000. Assuming a 6%* annual rate of return, her portfolio could grow to over $320,000 in today's dollars by the time she is 60. After accounting for a moderate 2% rate of inflation† the future value of her savings shrinks by over $100,000 or by almost one-third. It goes without saying that the higher the rate of inflation, the bigger the bite.



* For illustrative purposes only and not intended to reflect an actual rate of return or the future value of an actual mutual fund or any other investment.

† Inflation estimated using Bank of Canada's target inflation rate of 2.00%.

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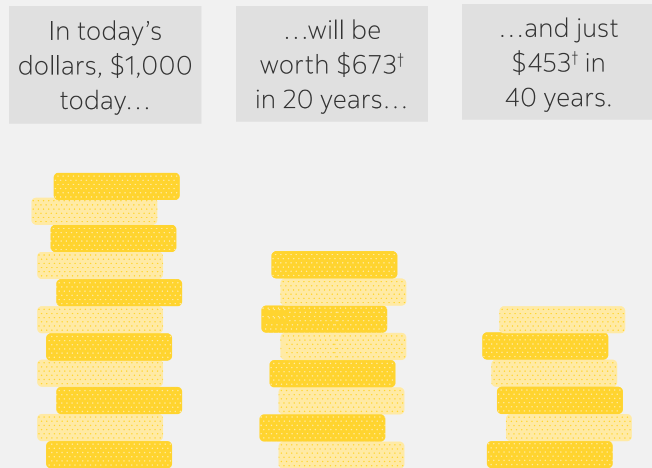
Spending years:

For every $1,000 Ruby spends today, she can expect to spend $1,486† when she plans on retiring at the age of 60. When Ruby is 80, that number would climb to $2,208†! To maintain her standard of living throughout her retirement years, Ruby will have to either save more now, live with less income, or earn an investment return that keeps pace with inflation over the long run.



† Inflation estimated using Bank of Canada's target inflation rate of 2.00%.

Strategies for long-term success:

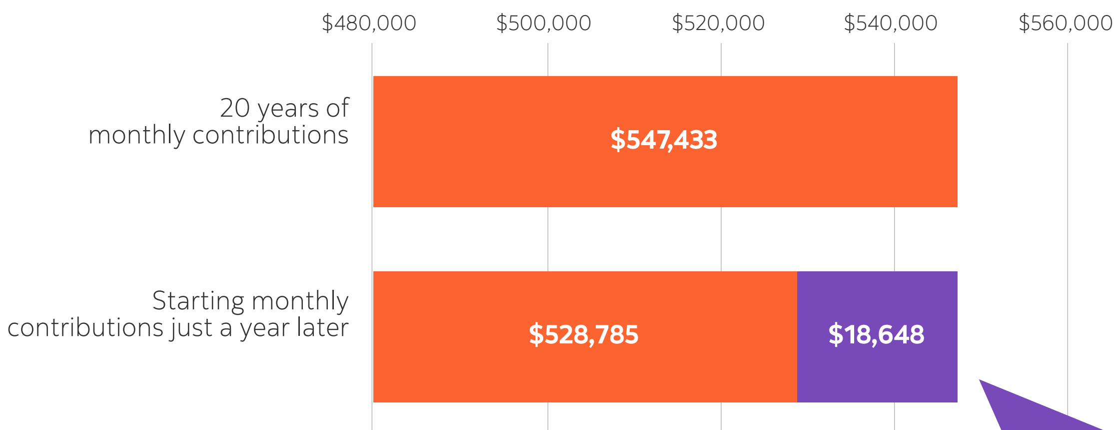
Don't let inflation deter you from saving now.

It might be tempting to forgo saving to spend on goods and services now just to avoid the anticipated price increases. Yet, inflation can be difficult to predict, and upticks or even sharp spikes can be transitory. A thoughtful approach to financial planning that includes regular contributions to your long-term savings can help you get ahead by simply not falling behind.

Let the power of compounding work for you.

With guidance from her advisor, Ruby decides to contribute $500 a month to her $100,000 portfolio. With regular contributions she could see her savings grow further from $320,714 to almost $547,433 in 20 years. If Ruby decides to delay her contributions by just one year, her potential savings could dip to $528,785.

Figure 1: Future value of a savings plan**



Potential savings lost due to delaying monthly contributions by just one year.

**Assumptions: For illustrative purposes only and not intended to reflect an actual rate of return or the future value of an actual mutual fund or any other investment. Based on an annual interest of 6.00%, a monthly contribution of $500.00 and an initial deposit of $100,000.

Stocks offer a hedge against inflation.

Many companies may pass on their higher costs to their customers, maintaining their profitability on an inflation-adjusted basis. Additionally, successful companies regularly evaluate and adapt their business model to navigate through the prevailing economic conditions. Between January 1, 2000, and December 31, 2021, the cost of a basket of goods and services in Canada increased by 49.3%[‡], compared to the broad Canadian stock market, which grew by 344.3%[¥]. Canadian bonds grew by 136.2% over the same period.[¥]

For Scotia Portfolio Solutions, our Portfolio Managers take an active approach to managing inflation risk by investing in companies that have pricing power and the potential to deliver higher returns to investors.

Canadian stocks outperformed the rate of inflation seven-fold between 2000 and 2021.

There are no silver bullets.

While stocks, gold, commodities, inflation-linked bonds, and other investments have offered periods of inflation protection over the years, the reality is that there is no one investment that can effectively hedge across all inflationary environments. Absent a crystal ball, diversification across a wide variety of investments is the most sensible approach to preserving the purchasing power of your savings.

A great starting point in your financial journey involves finding the right mix of stocks and bonds to suit your investment profile. Also known as your asset allocation, this step will likely be the largest contributor to the risk and return potential of your portfolio over the long run. While a higher allocation to stocks offers greater return potential, it comes with a corresponding increase in market volatility. A Scotiabank advisor can recommend a diversified portfolio that's built for all market cycles, including periods of rising inflation, and aligns with your risk tolerance and long-term return expectations.

Active management matters.

With interest rates near historical lows and inflation on the rise, being selective with your fixed income investments is more important than ever. Actively managed bond funds and portfolios take a tailored approach to investing versus passively managed index products that offer a more one-size-fits-all experience. Taking the prevailing and anticipated economic conditions into account, active bond managers use a variety of diversification tools across the fixed income universe to help preserve capital, manage interest rate risk, diversify credit risk and hedge against rising inflation.

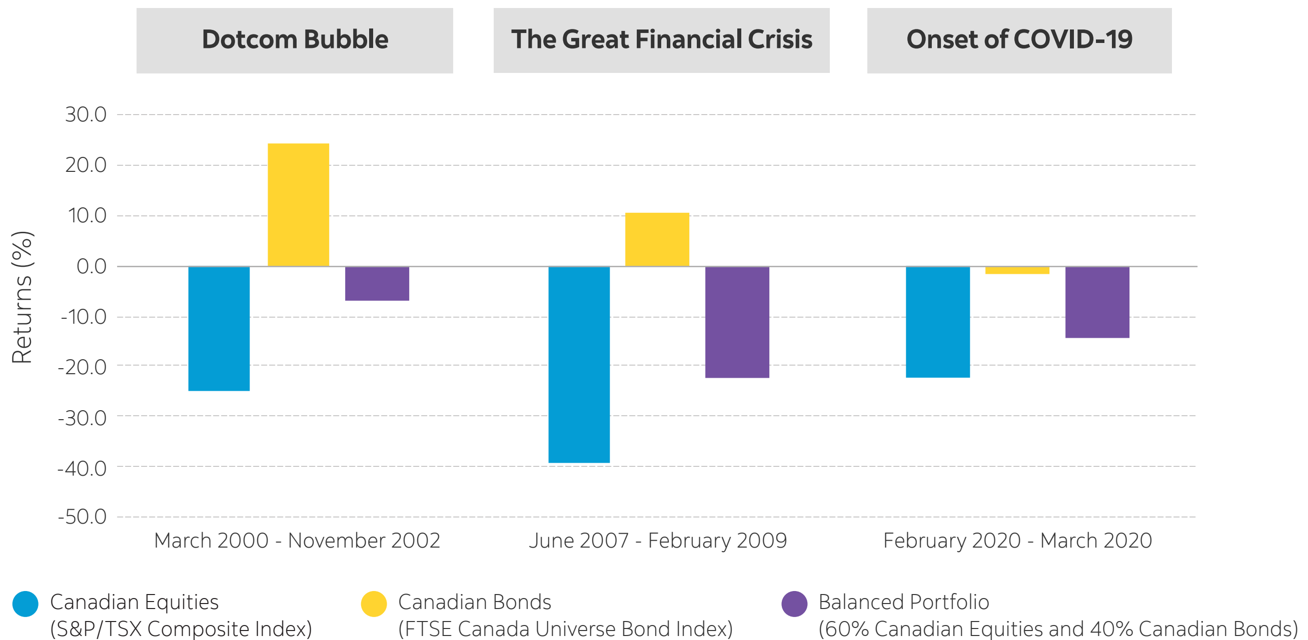
‡ Data Source: Statistics Canada, Consumer Prices Indexes, Monthly (V41690973 series.). As measured between January 1, 2000 and December 31, 2021.

¥ Performance for Canadian equities and Canadian bonds measured using S&P/TSX Composite Index (Total Return) and FTSE Canada Universe Bond. Source: Morningstar Direct. It is not possible to invest directly in an index. Assumes reinvestment of all income and no transaction costs or taxes.

Don't abandon bonds.

Some investors overlook bonds altogether to insulate their savings from rising inflation. But these investors can be left blindsided when volatility strikes. Just as stocks are the growth engine for your portfolio, bonds work as shock absorbers by dampening the impact of stock market volatility. See Figure 2 for three notable examples and why bonds are well placed in a diversified portfolio.

Figure 2: Canadian bonds during recent market shocks*



*Source: Morningstar Direct. It is not possible to invest directly in an index. Assumes reinvestment of all income and no transaction costs or taxes.

The bottom line

Inflation chips away at the real value of your savings over time and can often go unnoticed. Occasional flare ups like those witnessed more recently, while notable, are a reminder of the importance of having a financial plan and a well-diversified portfolio. They also demonstrate the need to regularly review your financial situation with your advisor to ensure that you are on the right path to achieving your long-term investment goals.

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