



INVESTING IN INFLATIONARY TIMES

Inflation can cause havoc for your personal finances as it erodes the real value of our money over time. Not surprisingly, research shows that as many as nine out of 10 people are worried about the effects it can have on their money (Source: Post Office Savings, June 2011). Inflation may have dipped slightly in June, but it is significantly above the 2 per cent target set by the Bank of England. It could yet rise above the 5 per cent barrier once the widely anticipated energy price hikes are taken into account later in the year.

If inflation ran at the Bank of England's intended target of 2 per cent, the sum of £100,000 would be worth £67,297 in real terms 20 years later. At 4 per cent the real value would drop to £45,639, while at 5 per cent the original sum of £100,000 would be worth just £37,689 in 20 years' time.

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In short, savers and investors need to have their wits about them if their money is to keep pace with inflation. But that is easier said than done, particularly given the wide disparity between inflation and interest rates.

Basic rate taxpayers need to earn interest of 5.25 per cent on their savings in order to make a real return on their money once CPI inflation is taken into account. Higher rate taxpayers are in an even worse position, needing returns of 7 per cent to stop the value of their deposits being shrunk by inflation. But with interest rates at rock-bottom levels, accounts paying such high rates are very few and far between.



In inflationary times, when the real value of level income payments is eroded over a few years, it is important to find good and increasing sources of investment income.

This is the big dilemma for many savers today. Not unreasonably, they do not want to lose a penny of their hard-earned cash. But with increasing life expectancy and potential long-term care costs to consider, they will need their money to work harder for longer - and this is likely to mean taking on more risk.

The question is where to start?

In the current inflationary environment the yields from gilts in real terms offer few attractions - a challenge for the government of course, because it continues to have a large funding requirement. Opportunities for attractive income still exist in the corporate bond market, however investors are having to be increasingly selective. Certain investment-grade bonds offer competitive yields and lower risk, while the 'high quality end' of the high yield - or non-investment-grade - market continues to present income seekers with some options.

The key for investors is to hold a portfolio of funds which offers the flexibility to exploit the selective income opportunities from across the corporate bond spectrum.

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One of the most efficient ways to beat inflation over the longer term is to invest in the stock market and take advantage of the dividends paid by companies. After a couple of leaner years in the teeth of the recession, the earnings of UK companies are looking far more healthy. On the back of those profits the outlook for dividends is more positive. History shows that returns on equities can beat inflation and dividends can play an important part in this. According to the Barclays Capital 2011 Equity Gilt Study, £100 invested in equities at the end of 1899 would be worth just £180 in real terms today without the reinvestment of dividend income; with reinvestment, the same portfolio would have grown to £24,133.

Diversification is also key in balancing risk and returns. For instance, commodities (such as those linked to food inflation) might be able to play a role in a balanced portfolio, so it is worth seeking out funds which invest in so-called 'alternative assets'. Another income producing asset, commercial property is also beginning to attract attention again. Returns are up 9.1 per cent over the 12 months to the end of June (Source: IPD UK Monthly Property Index Results, June 2011). Again, history suggests that commercial property has a place in a portfolio and its long-term track record is strong, while it offers diversification from equities.



Inflation also brings particular problems for people about to retire because even a low level of inflation will seriously dent pensioners' fixed incomes over a number of years. Anyone buying an income for life with their pension pot might assume that an annuity linked to inflation via the retail prices index (RPI) is the solution - these pay less income in the early years of retirement than a standard annuity, but eventually catch up and end up paying more later on.

But the decision is far from straightforward. How well RPI-linked annuities perform compared with "level" annuities depends on what happens to inflation, and you may have to live a long time after you retire for you to be "in the money". This is why it is crucial to get advice on the once in a lifetime decision about buying an annuity - once the decision is made, there is no going back.

Inflation and uncertainty go hand in hand, but it is even more marked given the current economic turmoil. It is why investors are going to have to explore all the options to make the most from their savings and investment - and maybe taking a step up the risk ladder.

COMPLIMENTARY GUIDES

INHERITANCE TAX	WEALTH MANAGEMENT	RETIREMENT PLANNING
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