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financial



U C C E S S

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Why Inflation Can Be Good and Its Opposite, Bad

Most people don't have a kind word to say about inflation, and those on fixed incomes hate it. Why? Because it makes everything more expensive; and when you're living on an income that never rises, your standard of living suffers.

But ask most economists and they'll tell you that within limits, inflation is a good thing, and its opposite — deflation — is a very bad thing. How can that be?

The broad definition of inflation is a general increase in prices. Deflation is the opposite — a general fall in prices. When we say "general," we're referring to the prices of most goods and services. This is an important distinction, because prices of some things move in a different direction from most.

For example, often regardless of what's happening to the price of food or clothing, prices generally

fall for new, high-technology items after a number of years. That's usually because manufacturers achieve economies of scale and are able to pass the associated savings along to consumers, and/or because they have invented new, less-expensive ways to make the latest gadget. It also happens when more manufacturers come into the market and compete against established makers on the basis of price.

There can also be regional differences in the prices of some goods.

An example is real estate, where prices may be falling in areas that are experiencing a high rate of job losses; while in areas where the job market is booming, housing prices are rising.

Three Measures of Inflation

1. The Consumer Price Index (CPI). This is the figure that most Americans think of when they think about inflation. It's calculated

Continued on page 2



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Why Inflation

Continued from page 1

monthly by the Bureau of Labor Statistics, based on the prices of a basket of some 80,000 different goods and services that most consumers buy in markets all across the country. The Bureau of Labor statistics categorizes those goods and services as:

- ✓ Food and beverages (including at-home and restaurant meals)
- ✓ Housing (rent of primary residence, owners' equivalent rent, furniture)
- ✓ Clothing and footwear (including jewelry)
- ✓ Transportation (new vehicles, airline fares, gasoline, motor vehicle insurance)
- ✓ Medical care (prescription drugs and medical supplies, physicians' services, eyeglasses and eye care, hospital services)
- ✓ Recreation (televisions, toys, pets and pet products, sports equipment, admissions)
- ✓ Education and communication (college tuition, postage, telephone services, computer software and accessories)
- ✓ Other goods and services (tobacco and smoking products, haircuts, and other personal services)

The CPI also includes sales and excise taxes, utility fees, and highway tolls. It excludes investments like stocks, bonds, and insurance, as well as income and Social Security taxes. You'll sometimes hear the expression "core inflation." This is a derivation of the CPI that excludes the goods that have very volatile prices, like food and fuel. The idea is to avoid outlying, short-run price changes that mask longer-term trends.

2. GDP deflator. Based on changes in Gross Domestic Product (GDP), this is a broader measure than the CPI because it includes

every kind of good and service the economy produces and delivers. For example, it includes raw materials and industrial goods, like steel, factory equipment, and investment services. It's expressed as a percentage that reduces the nominal new price of a good or service to reflect the quantity of goods. The GDP deflator is regarded as a more accurate measure of price trends throughout the *entire* economy.

3. Producer Price Index (PPI).

This measures changes in the wholesale prices of goods and services by manufacturers. It's often looked at as a leading indicator — to estimate later changes in the CPI.

How Inflation Can Be a Good Thing

Inflation is a byproduct of economic growth, which is the means by which the standard of living rises. Think of it this way: prices are a function of supply and demand; if businesses post higher prices for their goods and services and they stick, it's because demand is willing and able to pay those prices. One of the ways that people can afford to pay more is if their incomes are rising, which is what happens when they are working for successful companies. Higher prices are also supported when there is a continually growing number of people with jobs and money to spend.

Inflation can also stimulate growth by making existing debt cheaper. Think of homeowners who stretch their budgets to buy the nicest home they can afford. Over time, if the economy grows, so does their income. If they hold a fixed-rate mortgage, their monthly mortgage payment for principal and interest becomes a smaller and smaller percentage of their income. As a result, they have an increasing amount of free cash flow to spend on other goods and services. And in turn, that causes businesses to hire more people.

The Destructive Power of Deflation

Deflation is a general decline in prices and is a destructive economic force. For one thing, it's a sign that businesses can't pass along higher costs of production. Second, it results in lower revenue and cutbacks in production and employment. When people lose their jobs, they spend less, have trouble keeping up with their bills, and even lose their homes.

Third, deflation makes debt more expensive. As incomes and business profits decline, fixed-rate loans become an increasingly larger percentage of cash flow. Banks make fewer loans because fewer borrowers can qualify. People who still have jobs start paying off debt more aggressively. This further reduces demand for goods and services, and the economy goes into a negative feedback loop, feeding negative growth and higher unemployment.

Deflation is one of the major causes of economic depressions. In the 13 years from 1927 through 1939, the U.S. experienced CPI deflation in eight years, with prices falling 8.9% in 1931, 10.3% in 1932, and 5.0% in 1933. By comparison, during the Great Recession, we experienced only one year of very slight deflation, when the CPI fell by 0.4% in 2009.

The Inflation "Ideal"

Is there an ideal rate of inflation? Economists suggest that a "moderate" rate of inflation — in the low single digits — is optimal for sustained long-term growth. They point to U.S. experience: from 1900 through 2011, the U.S. averaged an annual growth rate of 3.3% a year, facilitated by an average annual rate of inflation of 2.9%. Indeed, the Federal Reserve Bank has said that an inflation rate of 2% to 3% is ideal. ○○○

Long-Term-Care Insurance: Considerations

Don't confuse long-term-care insurance with long-term disability insurance or Medicare. Disability insurance provides you with an income when you can't work because of an illness or injury. Medicare is government insurance to pay for medicine and medical treatment after you're 65 years old. Long-term-care insurance pays for people to watch over you when you're too weak or feeble to take care of yourself, including in-home care or living in an assisted-living facility or nursing home.

With people living longer than ever — the average American now lives to age 78½ — and baby boomers beginning to swell the ranks of the retired, demand for long-term care is likely to continue to grow. A Georgetown University study recently found that two out of every five Americans turning 65 will need more than two years of long-term care. While the average length of stay in a nursing home was 14 months in 2010, some people remain there far longer.

As with medical costs in general, long-term care is expensive and getting more so every year. According to a 2011 survey by Genworth, the national average for in-home care is more than \$43,000 a year. For a private room in a nursing home, the national average is more than \$77,000; and at 5% inflation, it's projected to cost \$193,000 per year in 20 years. And that's on



top of the cost of prescriptions, medical care, and hospital procedures.

For a number of years, people have been taking out long-term-care insurance policies against these costs to protect their nest eggs. But economics have also put the squeeze on the companies that offer long-term-care services; and over the past five years, 10 of the 20 major carriers have stopped writing new individual policies. The result is that the policies from the remaining carriers, which were already expensive, are becoming more expensive.

According to the American Association for Long-Term-Care Insurance, nationwide, the average long-term-care premium is \$2,350 a year for a 55-year-old couple and \$4,660 for a 65-year-old couple.

If you're considering taking out a long-term-care insurance policy, here are some key issues to think about:

✓ **You don't get a refund if you never use it or don't use it all.** About 30% of the population won't ever use long-term care. In addition, half of those admitted to a long-term-care facility stay only five months or less (it's the small number of people who stay much longer that raises the average stay to 14 months). Since, as with homeowners insurance, you don't build savings inside a long-term-care policy, if you never make a claim, you don't receive a penny back. So, taking your health and family history into account, you need to weigh the chances that you'll actually make a claim versus the value of saving and investing the money you would spend paying for it.

✓ **Premiums get more expensive the older you are.** Industry experts say the "sweet spot" for long-term-care premiums is the mid- to late 50s. If you're in that



age bracket, it can pay to make your decision before you get older.

✓ **It might become too expensive to keep.** With premiums skyrocketing, some current policyholders are being forced to cancel their policies without ever having filed a claim. As an alternative, they're considering scaling back on the potential benefits to keep their premiums low. Some of the strategies: reducing or eliminating the inflation-protection feature, reducing coverage from lifetime benefits to a maximum of three to five years, and using a policy as a supplement to personal funds instead of as the sole source of payment for long-term-care services.

✓ **Think about a "shared" policy.** Instead of taking out two separate policies for you and your mate, share a policy. It's more expensive than a single individual policy, but less than the cost of two policies.

✓ **Ask insurers about a "hybrid" policy.** This is a policy that marries long-term-care insurance either with an annuity or a life insurance policy that provides a living benefit to pay for health care costs.

Don't know what your best options are for long-term care? Please call if you'd like to discuss this in more detail. ○○○

Stretching Your IRA

Individual retirement accounts (IRAs) are usually viewed as retirement planning vehicles. But with increased contribution amounts and the ability to roll over 401(k) balances to an IRA, many IRA owners are finding they won't use the entire IRA balance for retirement. Thus, IRAs are increasingly becoming major estate planning tools. When used for estate planning, the goal is to extend the IRA's life as long as possible so that beneficiaries can benefit from the tax-deferred (for traditional IRAs) or tax-free (for Roth IRAs) growth. How can you accomplish that?

Assume you have a large traditional IRA balance, which includes a rollover from your 401(k) plan. You don't have to start taking distributions until age 70½. Then, you only take required minimum distributions calculated based on your life expectancy. When you die, you leave the IRA to your spouse, who rolls the balance over to his/her own IRA and names his/her own beneficiaries, perhaps your children or grandchildren. Your spouse delays distributions until age 70½ and then only takes required distributions. When your spouse dies, your children inherit the IRA, which can be divided into separate IRAs for each child. Each child can then take distributions based on each of their life expectancies and

can name their own beneficiaries. When your children die, their beneficiaries cannot reset the distributions based on their life expectancy, but the beneficiaries can continue to take distributions based on the previous owner's schedule until the IRA is depleted. By using this strategy and only taking minimum distributions when required, the balance can continue to grow on a tax-deferred basis for years or even decades.

The concept can be expanded further by converting a traditional IRA to a Roth IRA. Although income taxes will have to be paid on any amounts that would have been taxable when withdrawn (contributions and earnings in a deductible IRA and earnings in a nondeductible IRA), the income taxes can be paid with funds outside the IRA, leaving the IRA balance intact. Once the funds are in the Roth IRA, you do not have to take any withdrawals during your life. Since your spouse can roll the balance over to his/her own IRA, he/she would also not have to take withdrawals during his/her lifetime. When your spouse dies, his/her beneficiaries would then have to take distributions over their life expectancies, but qualified distributions would be taken free of federal income taxes. ○○○



Your 401(k) Contribution Amount

Before deciding how much to contribute to your 401(k) plan, find out three key figures:

What is the maximum percentage of your pay that can be contributed? The maximum legal limit that can be contributed in 2013 is \$17,500 plus an additional \$5,500 catch-up contribution for participants age 50 and over, if permitted by the plan. However, most employers set limits in terms of a percentage of your pay to comply with government regulations.

How much of your contribution is matched by your employer? Employers are not required to provide matching contributions, but many do.

Up to what percentage of your pay does your employer match? Most plans only match contributions up to a certain percentage of your pay.

Assume your 401(k) plan allows contributions up to 10% of your pay annually, with a 50-cent match on every dollar contributed, up to a maximum of 6% of your pay. With a \$100,000 salary, you can contribute up to \$10,000 to the plan. Your employer will match up to the first \$6,000 of contributions (\$10,000 times 6%), contributing a maximum of \$3,000. ○○○

Financial Thoughts

The gap between men and women in knowledge and awareness of personal finances is growing, according to a recent survey. Just 66% of women said they had general knowledge regarding stocks, bonds, and mutual funds versus 89% of men. Only 34% of women understood the tax implications of their investment strategies versus 56% of men. From a financial planning standpoint, fewer women than

men had a handle on how much they are spending each month (62% versus 78%). Only 52% of women were comfortable with their level of nonmortgage debt versus 71% of men (Source: *AAIL Journal*, July 2012).

Approximately 90% of women will be solely responsible for their finances at some point during their lives due to the death of a spouse or a divorce (Source:

Financial Finesse, 2012).

Those who have recently retired should resist the temptation to pull out of stocks when market conditions turn turbulent. Doing so eliminates the growth component of a portfolio and could increase the likelihood of running out of money from 20%–30% to more than 90% (Source: *T. Rowe Price Insights*, 2012). ○○○