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FACTSHEET

Money's too tight to mention

Don't let inflation reduce the value of your investment returns

Inflation can have a significant impact on our finances in a number of ways. But what exactly does it mean? And what impact could it have on our savings and investments? It's important to understand how inflation works, as well as the effects it has on our financial planning. As the American economist Milton Friedman remarked, 'Inflation is taxation without legislation.'

Put simply, inflation affects all aspects of the economy, from consumer spending, business investment and employment rates to government programmes, tax policies and interest rates. Understanding inflation is crucial to investing because inflation can reduce the value of investment returns.

INFLATIONARY PRESSURES IN AN ECONOMY

There are several different factors that may create inflationary pressure in an economy. Rising commodity prices can have a major impact, particularly higher oil prices, as this translates into steeper petrol costs for consumers.

Stronger economic growth pushes up inflation too, as increasing demand for goods and services places pressure on supplies, which may in turn lead to companies raising their prices. The falling pound since Britain's vote to leave the EU in June 2016 has also been a contributing factor, as it makes the cost of importing goods from overseas more expensive.

ERODING THE PURCHASING POWER OF YOUR MONEY

Inflation is not good news for savers, as it erodes the purchasing power of your money. Low interest rates also don't help, as this makes it even harder to find returns that can keep pace with rising living costs. Higher inflation can also drive down the price of bonds. These become less attractive because you're locked in at interest rates that may not keep up with the cost of living in years to come.

One option is index-linked gilts, which are government bonds whose interest payments and value at redemption are adjusted for inflation. However, if they're sold before their maturity date, their market value can fall as well as rise and therefore may be more or less than the redemption value paid at the end of their terms.

PROVIDING BETTER PROTECTION AGAINST INFLATION

Investing in equities can potentially provide better protection against inflation than deposit accounts or bonds, which aren't index-linked, because companies can raise prices to cover higher costs. That, in theory, should enable them to grow at the same rate of inflation over time.

However, investing in equities can carry a higher risk, and you must be prepared to accept that you could get back less than you put in and that the value of your investment may not keep up with inflation.

WHEN THE COST OF LIVING INCREASES

Companies that raise their prices in line with inflation tend to fare better than others when the cost of living is increasing. Energy companies, for example, may perform well in an inflationary environment as they can raise their prices in line with inflation. Infrastructure companies – such as those responsible for toll roads, government buildings and hospitals – may also do well, as they often have long-term government contracts in place with payments linked to inflation, which encourages private sector investment.

Other companies that tend to be resilient to inflation are those producing consumer staples, which will always be required, regardless of what happens to prices. These include companies that produce food and drinks or other essential items such as cleaning products, toothpaste and prescription drugs. ■

CONCERNED ABOUT THE EFFECTS OF INFLATION ON YOUR INVESTMENTS?

Inflation can eat away not only at your capital growth, but also the value of dividend payments, which will not usually keep pace with rising inflation. With a weaker pound following the Brexit vote pushing up import costs and contributing to rising prices, this is potentially bad news for investors. To take stock of your particular situation, please contact us.

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