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How to manage the **harmful effects of inflation** on your wealth

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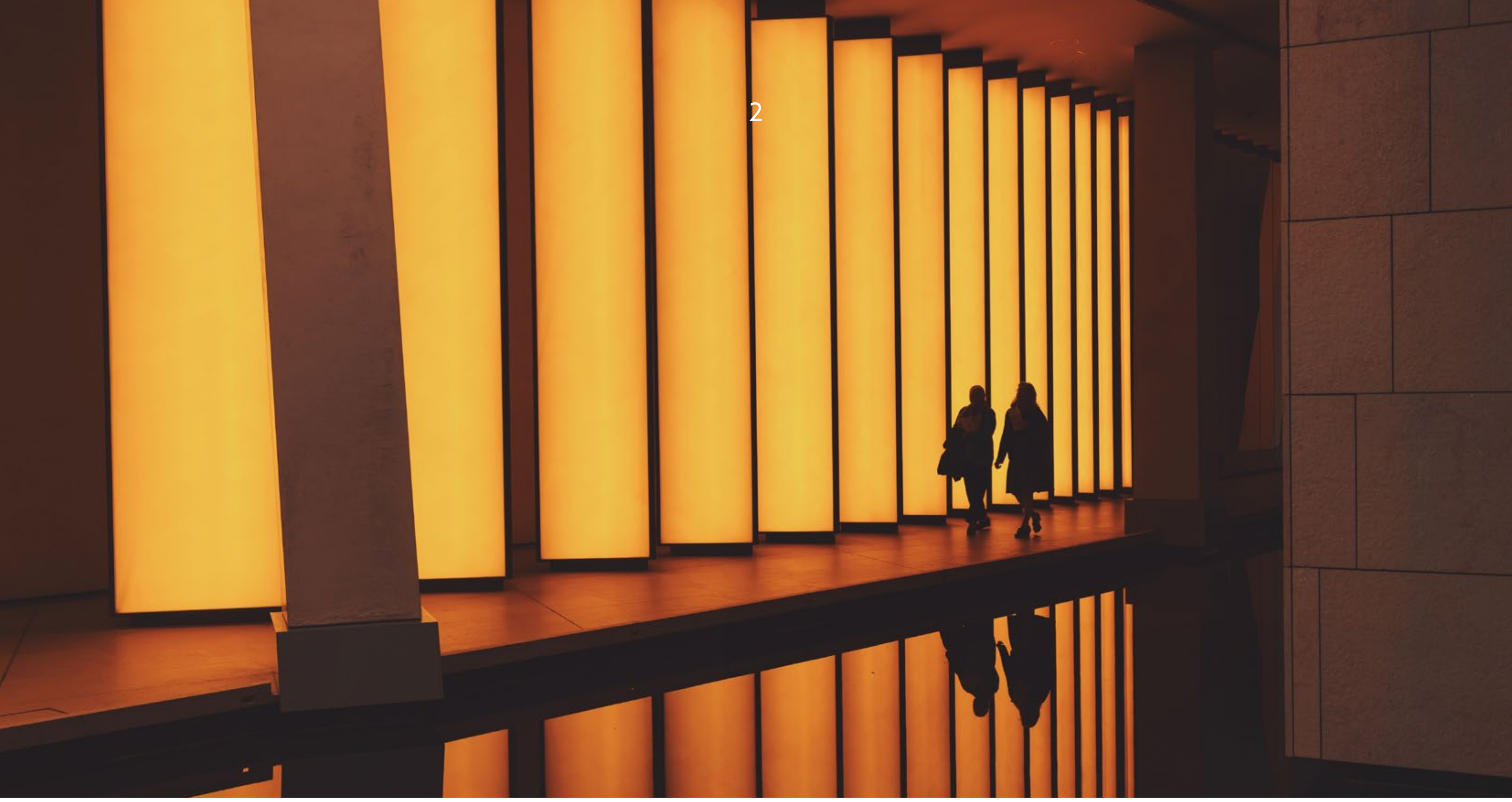


How to manage the harmful effects of inflation on your wealth

Over the last year, inflation has been high. It's likely to have affected your day-to-day costs, and it could harm your long-term wealth too.

According to a Canada Life study, 83% of financial advisers said inflation was the number one concern for their clients this year.

If you're worried about inflation, read on – this guide explains why inflation may alter your long-term plans and what steps you could take to reduce the impact.

The rate of inflation has been in double digits for much of the last year

In the 12 months to April 2023, the rate of inflation was 8.7%, according to the Office for National Statistics data. In fact, for much of the last year, the Consumer Prices Index (CPI) has been in double digits and far higher than the Bank of England's 2% target.

The high levels of inflation have been linked to the Covid-19 pandemic and lockdown, as well as the war in Ukraine. Both of these global events affected business operations and the cost of goods and services.

Royal London research estimates the average UK household is paying an extra £441 a month in bills when compared to just a year ago. The main drivers for the increase are energy bills and mortgage payments.

Why are interest rates rising?

Increasing interest rates is one of the ways the Bank of England (BoE) is trying to slow down the pace of inflation.

Higher interest rates increase the cost of borrowing. So, it's hoped that by increasing the interest rate, people spend less and save more. Lower demand can lead to prices falling or remaining static, so the rate of inflation declines.

In November 2021, the BoE's base interest rate was just 0.1%. Following a series of rises, it stood at 4.5% as of May 2023.

As a result, if you've borrowed money, whether through a credit card or mortgage, it's likely your debt repayments have increased.

2 significant ways inflation could affect your wealth

1. You'll need to spend more to maintain your lifestyle

From your utility bills to trips out, you may be spending more than you were a year ago. High inflation means your outgoings have probably increased just to maintain your lifestyle.

For some families, this has placed their day-to-day budgets under pressure and means they need to cut back. Reviewing your expenses may be something you've already done.

Rising costs could also affect your long-term plans.

Perhaps soaring energy bills mean you're no longer putting as much into your savings or investments? Or you may even be considering cutting down your pension contributions as a result?

A report in *PensionsAge* found 51% of employers have had employee requests to reduce pension contributions, and 47% have received requests to stop contributions altogether.

While this may seem like a good way to balance your budget now, it could have serious implications for your future. Even pausing pension contributions could mean you don't have enough to retire or you need to adjust your lifestyle expectations.

If you're considering making changes to your financial plan because of inflation, it's important to weigh up the long-term consequences.

Review your long-term plan before increasing pension withdrawals

If you're using your pension or other assets to create an income, you need to be mindful of how higher withdrawals could affect sustainability.

While you may be tempted to increase withdrawals to reflect rising costs, you'll be depleting your pension at a faster rate. It could mean you risk running out of money in your later years if taking a higher income wasn't part of your financial plan. Please contact us to review your long-term plan and assess if higher withdrawals would be sustainable.

2. The value of your assets may fall in real terms

Inflation can also affect the value of some of your assets in real terms, especially cash.

If the value of assets doesn't rise in line with inflation, their spending power shrinks. Over time, what you can buy with the assets will gradually fall. So, while the numerical value may remain the same, in real terms, your wealth is declining.

Take money in a savings account: while the amount in the account may increase as interest is added, it's unlikely that it's growing at the same rate as inflation. The difference may seem minimal when you compare the value month-to-month, but, over time, the effect can be significant.

If you placed £20,000 in a savings account in 1980, the BoE calculates you'd need more than £75,600 in 2022 just to maintain your spending power. This is due to an average rate of inflation of 3.2% a year.

During a period of high inflation, the effects can be even more harmful to your long-term plans.

5 valuable ways you could "beat" inflation

While you can't stop inflation, there may be things you can do to lessen the effect it has on your wealth. Here are five things you could do to "beat" inflation.

1. Make the most of suitable allowances

Allowances could help you get more out of your money by reducing how much tax you pay. With inflation potentially reducing the value of assets in real terms, reviewing how you could cut your tax bill could provide some balance.

There are many different allowances, and which ones are right for you will depend on your circumstances and goals. Here are some commonly used allowances:

ISA annual allowance: If you want to build up your savings or investments, an ISA could make sense. For the 2023/24 tax year, the ISA annual allowance is £20,000. You don't pay Income or Capital Gains Tax (CGT) on the interest or returns you make on assets held in an ISA.

Marriage Allowance: If your spouse or civil partner doesn't use all their Personal Allowance (£12,570 for the 2023/24 tax year), they could pass £1,260 of it on to you if you're a basic-rate taxpayer. It could reduce your Income Tax bill by £252 a year.

Capital Gains Tax annual exempt amount: CGT may be due if you make a profit when selling some assets. However, with the annual exempt amount, you don't need to pay CGT if your cumulative profits are below £6,000 in 2023/24. The annual exempt amount will fall to £3,000 for the 2024/25 tax year.

Dividend Allowance: You may receive dividends from your investments or from a business you own. In 2023/24, you can receive up to £1,000 in dividends before tax is due. You should note that Dividend Allowance will fall to £500 in April 2024.

Many allowances are for individuals. So, if you're planning with your partner, you should consider how to make use of both of your allowances.

Contact us to discuss which allowances could be appropriate for you and how they could form part of your long-term plan.

2. Shop around for the best interest rate

Soaring inflation could be harming the value of your savings in real terms. However, rising interest rates could present a way to reduce the effect.

After more than a decade of low returns on savings, interest rates have been creeping up over the last year. Shopping around for a better rate could mean your money is working harder.

If you have a lump sum of £50,000 in your savings account, with an interest rate of 1%, you'd receive just £500 in interest each year. But if you shopped around and transferred your money to an account with an interest rate of 3.5%, it rises to £1,750.

If you don't need easy access to your savings, an account that locks the money away for a defined period could provide a more competitive rate of interest.

3. Consider if investing is right for you

While interest rates are rising, they are still unlikely to match the rate of inflation. If you're saving for long-term goals, investing could be suitable.

Historically, investment markets have delivered returns that have outpaced inflation over the long term. An investment strategy that's tailored to you could play a role in growing your wealth in real terms.

It's important to note investment returns cannot be guaranteed. As markets can be volatile, you should usually invest with a minimum time frame of five years, as this can allow the ups and downs to smooth out.

You will also need to consider things like your risk profile and other assets you hold when making investment decisions. Please contact us if you'd like to discuss whether investing is right for you.

4. Review your budget

One of the challenges of managing the effects of inflation is that as your everyday spending rises, your long-term financial freedom may suffer.

So, take some time to understand how your expenses have changed over the last 12 months. Does your budget still cover your outgoings, or are you having to cut back your savings? It can help you identify where your everyday spending could affect other areas.

You may find that you need to adjust your day-to-day spending to meet long-term goals, or you could be in a better position than you thought. What's important is that you understand how inflation is affecting your short- and long-term finances.

While the inflation rate in the 12 months to April 2023 was 8.7%, it doesn't mean your expenses will have increased by this amount. It will depend on your lifestyle, so calculating your personal inflation rate could be valuable.

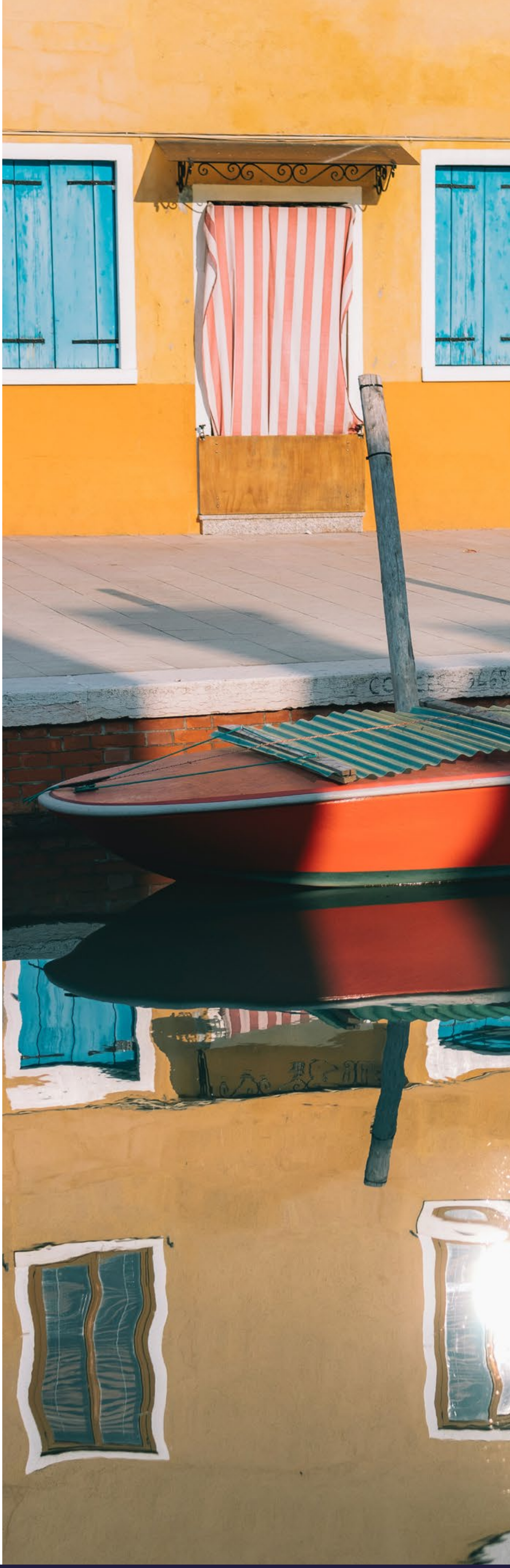
Could annuities provide a solution for retirees?

The introduction of Pension Freedoms legislation in 2015 gave retirees more freedom to create an income that suits them. The option to take a flexible income through flexi-access drawdown led to annuities falling out of favour, but they could be valuable in a high inflation environment.

You can use your retirement savings to purchase an annuity, which would then provide a guaranteed income for the rest of your life. Crucially, you can often choose an annuity that will deliver income that rises in line with inflation. This would protect your spending power throughout retirement.

There are pros and cons to weigh up when deciding if an annuity is right for you. However, being able to link your income to inflation could make annuities an attractive option for some retirees.

Contact us to discuss your pension options.



5. Focus on your long-term plan

While inflation is high now, the BoE forecasts it will decline quickly in 2023 due to wholesale energy prices falling and an expected sharp fall in the prices of imported goods.

Focusing on the long term could help ease your concerns about inflation. Inflation may have affected your wealth, but you'll likely have opportunities to make up potential shortfalls in the future. A long-term financial plan can help you set out what you want to achieve and the steps you need to take to reach goals.

It can also provide a chance to consider what would happen if inflation was high in 10 or 20 years. Thinking about potential obstacles could mean you're in a position to mitigate the effects and have a greater chance of securing the future you want.

Contact us to talk about how inflation could affect your long-term plans

If you're worried about how high inflation could affect your long-term wealth, please contact us. We'll work with you to create a financial plan that reflects your circumstances and priorities.

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Please note: This guide is for general information only and does not constitute advice. The information is aimed at retail clients only.

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Past performance is not a reliable indicator of future performance.

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