Interest Rates, Inflation and Your Investments

Q. What impact might inflation have on the value of my 401(k) plan?

A. Even a little inflation over the years could erode the buying power of your retirement savings, potentially leaving you with less than you hoped for. Say you have $100,000 in your 401(k) account. Even 4%-a-year inflation would, over five years, reduce the buying power of that $100,000 by around 20%. Imagine how quickly this would be reduced if inflation jumped to 9%, as it did in the 1970s. Of course, you don't just stand by and watch inflation derail your retirement plans. The allocation you choose should take the potential effects of inflation into account. It is recommended that at least part of that allocation is in growth investments, whose long-term returns have historically outpaced inflation. Of course, past performance is no guarantee of future results.

Q. How might rising interest rates affect my 401(k)?

A. In the short-term, higher rates have historically tended to depress the value of bond funds. If newly issued bonds are yielding 8%, owners of older, lower-interest-rate bonds would have to cut prices sharply to sell them. So prices of existing bonds owned by bond mutual funds have tended to decline—as has the value of the mutual fund. Longer-term, however, those higher interest rates translated into more income coming into your bond funds because the fund manager began buying new bonds at those higher interest rates. And then any potentially larger dividends from the bond funds would flow to you.

Q. Why not invest only in stocks?

A. Stocks offer the growth potential to outpace inflation, but stocks are also volatile investments. A sound asset allocation may include bonds and money markets because they have historically been less volatile than stocks.

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