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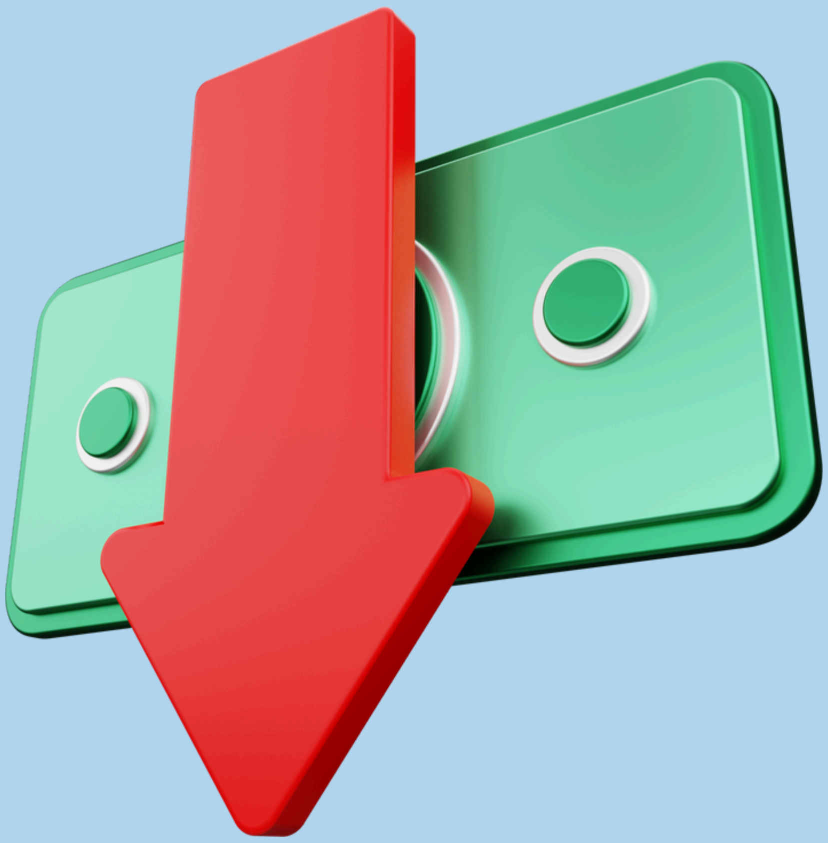
How Does Inflation Affect Pension Savings?

BETTER FINANCE
The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

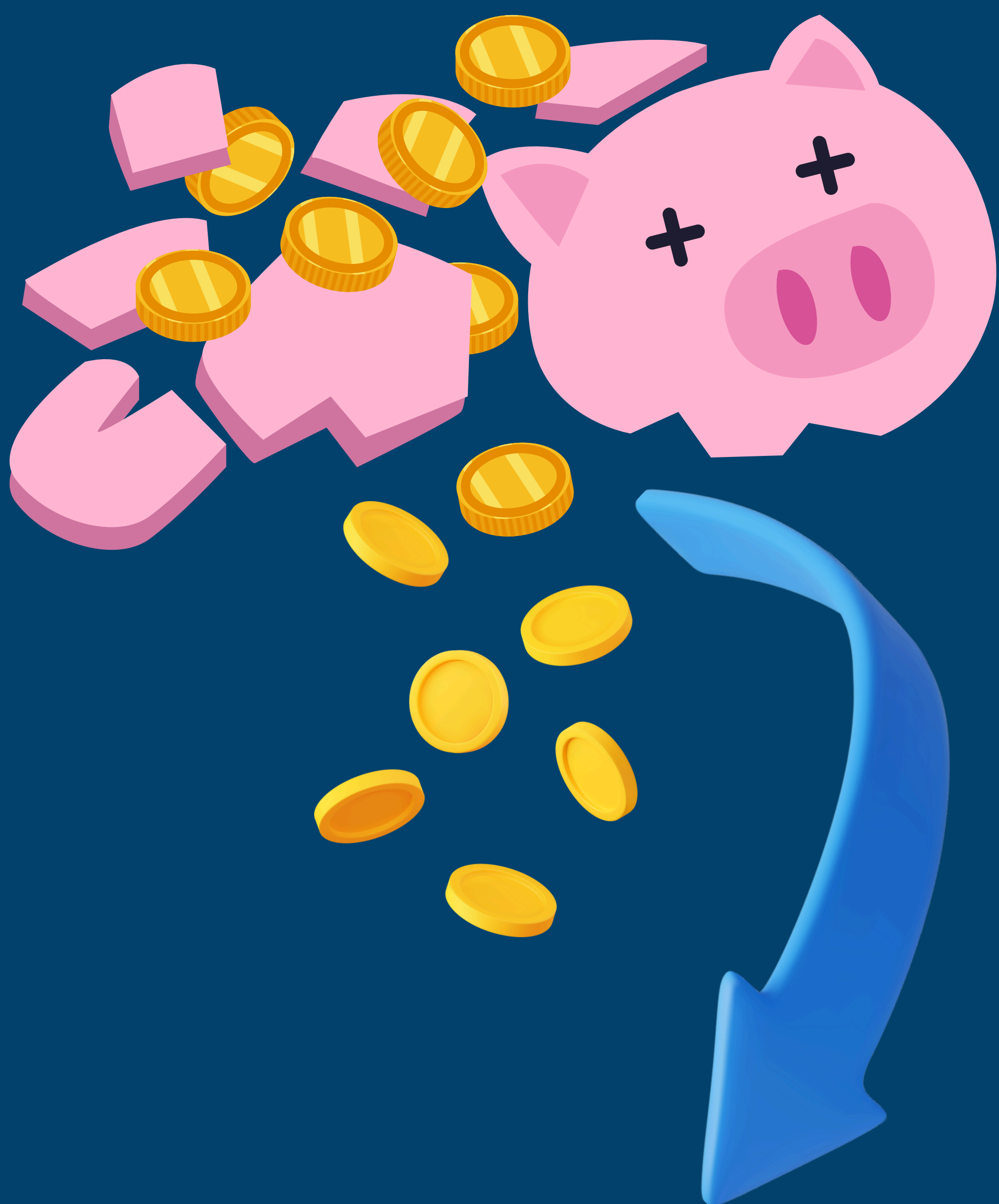
What is inflation?

Inflation constitutes an increase in the general level of prices, meaning that the same amount of money can no longer buy the same amount of a given good or service.



Inflation reduces the value of money.

The purchasing power of savings made one year in the past is reduced by the inflation that occurred during that year.



But how does inflation affect long-term or pension savings?

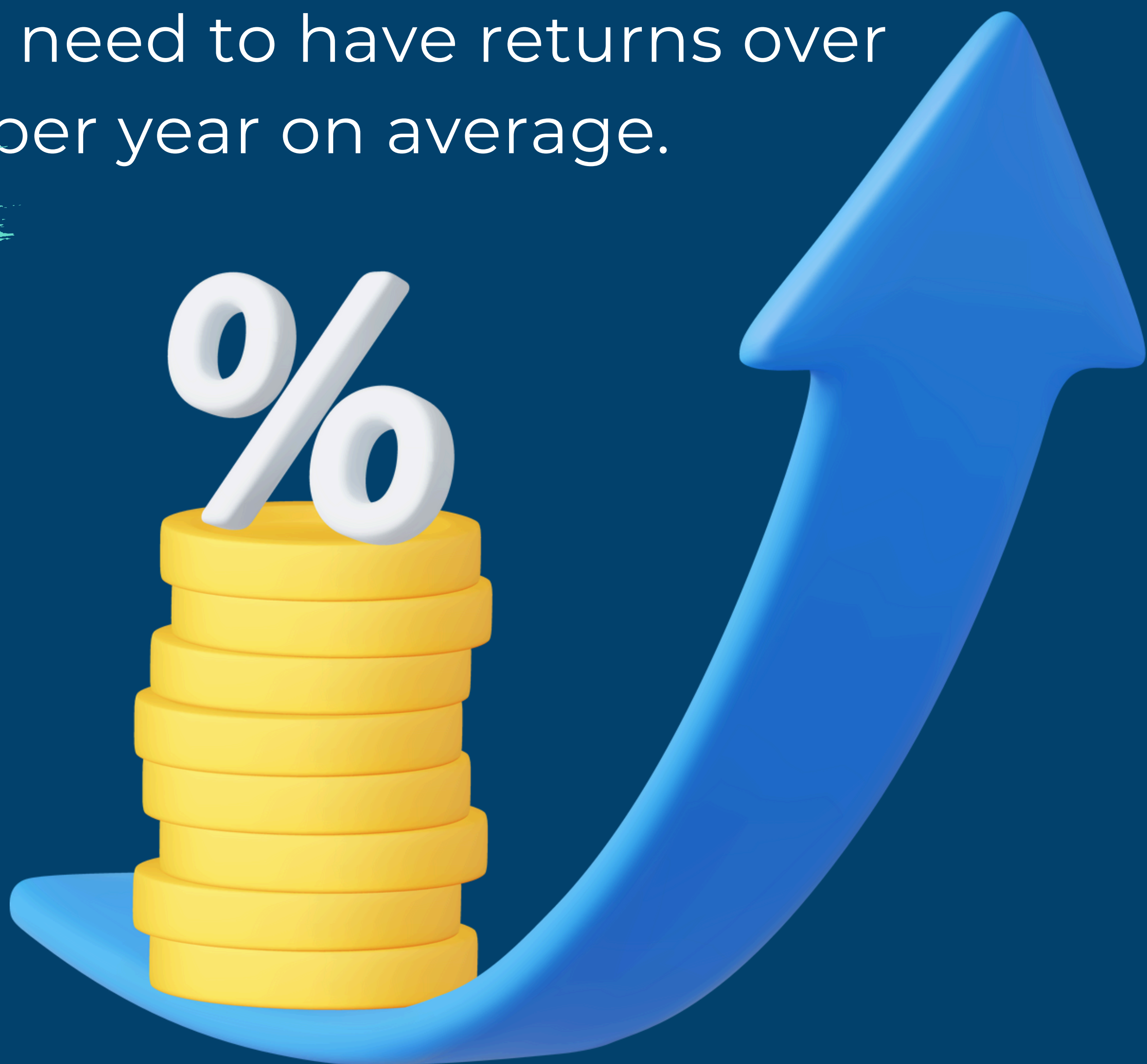
1. Inflation erodes the purchasing power of money.

The European Central Bank (ECB) had set its medium-term inflation target at "**below but close to 2%**", a level at which prices are considered "stable".

Yet, over 20 years, that "normal" level of inflation could result in a **58% reduction** in the purchasing power of savings.

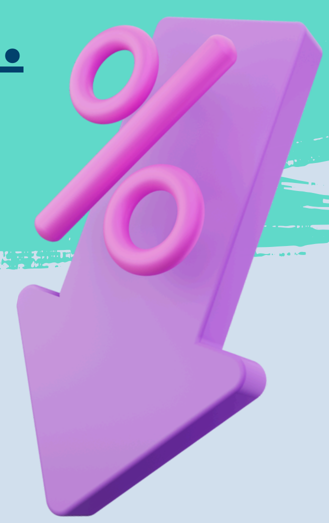
During the 2000-2020 period of exceptionally low inflation (on average 1.75% per year), it amounted to a **44.07% reduction in the purchasing power** of each euro over two decades.

To avoid investors losing purchasing power over that period, their long-term or pension-saving products would need to have returns over **1.75%** per year on average.



2. Inflation can affect the real returns on investments.

In BETTER FINANCE’s 2022 pension report, after adjusting for inflation, the median performance of pension products in real terms **falls to –19.4%**, with the **best performance at -4.2%,** and the **worst at -29.3%.**



All products experienced a loss in purchasing power due to inflation.

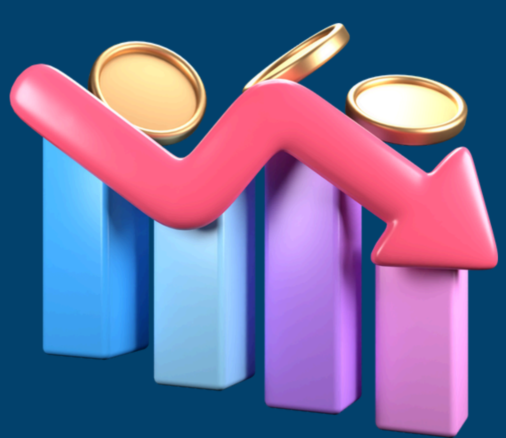
Such a situation could render the income we receive during retirement insufficient to maintain the standard of living we enjoy while employed.

3. Inflation can inflate the effective tax rate on pension savings.

Deferred taxation regimes incentivise savings by allowing individuals to deduct their pension contributions from their taxable income.

However, these deferred tax regimes may work at the disadvantage of savers:

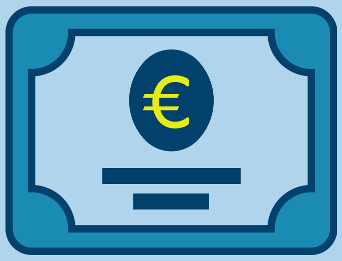
between the time of contribution and the time of payout, **inflation will have significantly reduced the actual purchasing power** of those contributions.



As a result, the real value of the pension payouts is significantly less than what has been paid overtime.

What can safeguard pension savings from inflation?

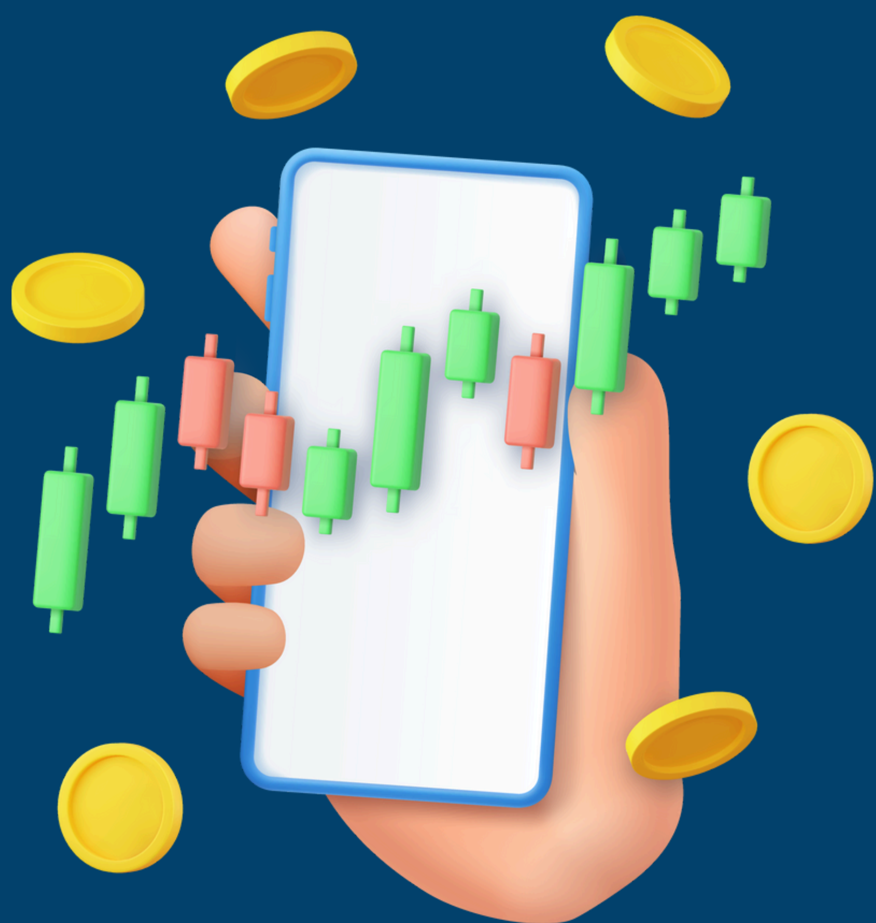
To effectively protect pension savings against inflation, BETTER FINANCE recommends ending the **fixed-income bias** in the asset allocation of long-term savings.



Bonds tend to offer lower returns that may not keep pace with inflation.

Instead, a more balanced approach that includes a significant allocation to **equity markets**, which, despite their higher volatility, offer higher yields over the long term, may be preferable.

This approach can be managed through life-cycling strategies that adjust the risk exposure according to the investment horizon of the saver.



An example is Sweden's AP7 Såfa fund, which invests 100% in equity for younger savers and gradually shifts to fixed-income assets as they approach retirement age.

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