

How Much Is Inflation Costing You Each Year?

Inflation is one of the most important, yet often overlooked, forces in personal finance. At its core, inflation refers to the general increase in prices over time. As the cost of goods and services rises, the purchasing power of your money declines. In other words, the same dollar buys less in the future than it does today. While modest inflation is normal in a growing economy, even low levels of inflation can significantly impact your savings and investments over time.



The Impact on Savings

Cash savings are particularly vulnerable to inflation. While keeping money in a traditional savings account offers safety and liquidity, it rarely provides returns that outpace inflation. For example, if you earn 2% interest on your savings and inflation is 3%, your real return is actually -1%. This means you're effectively losing money in terms of purchasing power—even though your account balance is growing.

Certificates of deposit (CDs), money market accounts, and other low-risk cash equivalents face the same problem. Their interest rates may be higher than a basic savings account, but they're still typically below the rate of inflation, especially in a low-interest-rate environment. Over time, this erosion can be significant. A savings account that seems to be growing on paper may lose its ability to cover future expenses like healthcare, housing, or education.

The Impact on Fixed-Income Investments

Fixed-income investments such as bonds are also impacted by inflation. These assets pay a set amount of interest over time, but if inflation rises, the value of those fixed payments declines. For example, if you hold a bond that pays 4% interest annually and inflation rises to 5%, you're earning a negative real return. Long-term bonds are especially susceptible to inflation risk because they lock in lower interest rates for longer periods, giving inflation more time to reduce their value.

Even bond mutual funds or ETFs that adjust their holdings regularly can be affected, especially during periods of rising inflation and interest rate volatility.

The Impact on Equity Investments

Equities (stocks) are generally better positioned to outpace inflation over the long term. Companies can raise prices to keep pace with inflation, which can help protect their profit margins and, by extension,

investor returns. While stock markets can be volatile in the short term, a well-diversified equity portfolio has historically offered growth that outpaces inflation.

However, not all stocks are created equal. Inflation can increase costs for companies, reduce consumer spending, and pressure profit margins—especially for companies with limited pricing power. That’s why asset selection and diversification across sectors, industries, and geographies are important.

The Role of Real Assets and Inflation-Protected Securities

Certain assets, like real estate and commodities, tend to perform well in inflationary environments. Real estate often benefits because property values and rental income can rise with inflation. Commodities like gold and oil are also considered hedges against inflation, although they come with their own risks and volatility.

Another option is Treasury Inflation-Protected Securities (TIPS), which are government bonds indexed to inflation. The principal of a TIPS bond increases with inflation, helping to preserve purchasing power. These can be useful for more conservative investors looking to protect part of their portfolio from inflation risk.

How Inflation Impacts Financial Planning

Inflation is especially important to factor into long-term financial goals like retirement, college savings, or legacy planning. If you estimate you’ll need \$60,000 a year to retire comfortably today, you might need closer to \$90,000 in 20 years to maintain the same lifestyle, assuming a 2.5% annual inflation rate.

Failing to account for inflation can result in under-saving and outliving your assets. That’s why every financial plan should include inflation-adjusted projections and regularly reviewed strategies that adapt to changing economic conditions.

Strategies to Stay Ahead of Inflation

To protect your financial future from the impact of inflation, consider the following actions:

- **Diversify your investments** across asset classes, including equities, fixed income, and real assets.
- **Rebalance regularly** to maintain your target risk level and growth potential.
- **Use tax-advantaged accounts** to maximize long-term returns (like Roth IRAs or 401(k)s).
- **Incorporate inflation-protected assets**, such as TIPS or inflation-sensitive mutual funds, as appropriate.
- **Avoid holding excess cash** in low-interest accounts beyond what you need for emergency savings.

Inflation may be subtle, but over time, it has a powerful impact on your financial well-being. Whether you're saving for retirement, investing for future goals, or simply managing your monthly budget, understanding and planning for inflation is essential. The good news is, with the right strategy, you can stay ahead of it.

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