The Stan Clark Financial Team's

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Asset Allocation

Thinking for the long term: life expectancy and inflation

By Stan Clark, Investment Advisor, and Michael Chu, Investment Advisor

Life expectancy and inflation are probably two of the least popular topics in the world of finance. But just because people don't want to talk about these topics doesn't mean they're not important! In this article, we discuss the effects of life expectancy and inflation – and show that, in fact, they are indeed very important.

Most people are reluctant to plan too far ahead. However, you need an idea of your life expectancy to make shorter-term decisions, such as how much money you can spend during your retirement.

The average life expectancy has been steadily increasing. For a 65-year-old male, the average life expectancy is 86. For a female, it is 89. Moreover, the older you are, the longer you can expect to live. Below is a table of average life expectancies:

Average life expectancy (years further)

Age	Male	Female	Joint
65	86 (21 years)	89 (24 years)	91 (26 years)
70	87 (17 years)	90 (20 years)	92 (22 years)
75	89 (14 years)	91 (16 years)	93 (18 years)
80	91 (11 years)	93 (13 years)	94 (14 years)

Source: Canadian Institute of Actuaries (1997-2004)

The third column in this table shows the life expectancy of a couple. You may have noticed that the joint-life expectancy is longer than the life expectancy of either spouse. Now, this doesn't mean married people live longer. It's just that you have to plan for both spouses to die instead of just one. After all, since there are two people involved, it's reasonable to expect that at least one of them could live longer than average. What this means is that, people need to plan for a long life – and couples need to plan for even longer lives.

With such long time horizons to consider, we need to watch out for inflation. The cost of a Big Mac hasn't changed much between today and a year ago. But do you remember what it cost 10 years ago? How about when we were kids? A Big Mac then cost significantly less! Inflation has a huge negative effect over time – and money is only as good as what it can buy. People shouldn't fool themselves into thinking inflation won't significantly affect their wealth. Furthermore, all planning should be based on the real value of their wealth, that is, factoring in the effects of inflation.

Over the past 100 years, inflation has averaged about 3%. At first glance, this might not seem significant. However, as you can see in the table below, 3% inflation over 10 years means a 26% loss in the real value of your wealth. And, over 30 years, inflation consumes 60% of your wealth!

Loss due to inflation over time

Time	2% Inflation	3% Inflation	4% Inflation
10 Years	18% loss	26% loss	34% loss
20 Years	33% loss	46% loss	56% loss
30 Years	45% loss	60% loss	71% loss

Source: calculations performed by Stan Clark, CFA, CFP, MBA

The good news is that we can do something about this. On average, investing in bonds returns about 4%, just barely above the average inflation rate. But stocks return about 10%, well above the inflation rate. Investing properly can help offset the negative effects of inflation.

The key is to determine the right balance of stocks and bonds that is appropriate for you, based on your risk tolerance and your goals. Our integrated approach to financial planning, based on your input, can help you plan properly for both life expectancy and inflation. ■

Stan Clark is First Vice-President, Portfolio Manager and Senior Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Stan has direct responsibility for the team and oversees all areas of financial planning, investment selection and investment management.

Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

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Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca