How inflation eats into your returns

Understanding inflation and its impact on your portfolio is important because rising prices can reduce the value of the money you get back from your investments.

What is inflation?
Inflation is a term used to describe a rise in prices. In the UK, it is measured by the Consumer Prices Index including owner-occupiers' housing costs (CPIH), the Retail Prices Index (RPI) and the Consumer Price Index (CPI). CPI is the most commonly quoted measurement and tracks the changes in prices of several hundred household goods and services including food, clothing and recreation. The Office for National Statistics publishes CPI figures on a monthly, quarterly and annual basis.

Prices increase for a variety of reasons, such as a rise in the cost of the raw materials used to manufacture goods, or tax cuts which encourage consumers to spend.

In the UK, inflation has drifted above the Bank of England’s (BoE) target of 2% since the Brexit referendum as political uncertainty has caused sterling to weaken against other major currencies. Weaker sterling means goods imported from outside the UK become more expensive.

Most other major central banks set a similar target because a healthy level of price rises reflects a strong economy. If inflation races ahead for any reason, the banks can use interest rates to get it back under control.

Why does inflation matter to investors?
Inflation reduces what is known as your purchasing power. In short, when prices rise, you can buy less with your money. This effect does not just impact your day-to-day spending though, it also eats into the returns generated by your investments.

Say your portfolio increased in value by 5% in a year. This is your nominal rate of return. However, prices rose by 2% during that time, consistent with the BoE’s target. To determine your real rate of return, you need to subtract the inflation rate (2%) from your nominal return (5%). In this case, the value of your portfolio increased in real terms by 3%.

Inflation proofing your portfolio
An investment portfolio should ideally be designed to deliver returns that beat inflation over the long term (five to ten years), even if it does not achieve this aim consistently throughout the whole investment period.

Bonds play an important role in the diversification of risk in your portfolio, but they may underperform when prices rise because payments become worth less. Fixed interest payments received by bond investors stay the same regardless of inflation, while equity investors earn a variable return which they expect, to some degree, to reflect changes in inflation. Alternative asset classes such as

commercial property and commodities might also benefit from rising prices. Conversely, with interest rates at record lows since the 2008 financial crisis, holding cash will generate negative returns.

The value of your investments can fall as well as rise, and you could get back less than you invest.