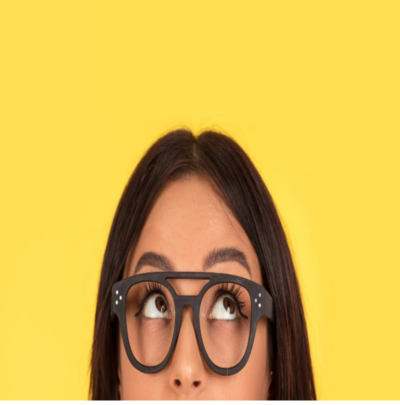

Here’s How Higher Inflation Can Cut Your Investments in Half…

Description

Last week, Statistics Canada set off a whirlwind of news when it released the inflation rate for April: 3.4%. Almost triple the rate we saw in February, 3.4% is the highest inflation rate we’ve seen since May 2011.

Now, hear me out: I don’t think inflation will stay at 3.4% forever. If it does, the Bank of Canada will step in and create measures to bring it down.

But, as a thought experiment, I asked myself: “What if inflation *did* stay at 3.4%? How would that affect our return on investments?”

To answer that, we need the rule of 72.

The rule of 72

Perhaps one of the most ancient rules of thumb available — Italian mathematician, Luca Pacioli, first referenced it in 1494, but most believe it’s older than that — the rule of 72 is often used to calculate how long it will take an investment to double, given an average annual rate of return.

If you believe, for example, the annual rate of return on the **S&P/TSX Composite Index** is 9%, then, according to the rule, your stocks will double in eight years (72 / 9% = eight years).

It’s an estimate. But it’s a calculation you can do in your head. Just divide 72 by your rate of return, and you’ll see how long it will take for your money to double.

The rule of 72 and inflation

What most people don’t realize is that you can apply the rule of 72 to any compounding rate, including loan interest, investment fees (MERs), and, yes, even inflation.

When applied to inflation, the rule of 72 helps us see how long it will take an investment to lose *half* its value.

So, let's say inflation stayed at 3.4%. At that rate, an investment will lose half its value in 21.17 years (72 / 3.4% = 21.17 years), which is roughly 21 years and 62 days.

But, truthfully, that's not completely accurate. The law of 72 works best for percentages between 6% and 9%. Anything above or below requires a more advanced law of 72.

Let me just say, the advanced law involves more math. And if you trust me with the logarithms and formulas, I'll just go ahead and reveal it: **at 3.4% inflation, your investments will lose half their value in 20 years and 262 days.**

Putting it all together

What that means for you is this: if you're near retirement and you're sitting on a hefty nest egg, you have around 20 to 21 years before your nest egg loses half its value, if the inflation rate stays the same. For a nest egg of $1 million, in 20 years, it will be worth $500,000 in today's dollars. You can see why this might be alarming for many investors.

Should you be worried?

Like I said, I don't think inflation will stay at 3.4%. But no matter where the rate falls next month, or the month after, your best defence is to stay invested in the stock market for the long term.

Though many of the TSX's great stocks will help you hedge against inflation, you might want to consider companies with a longer history of growth, such as those that deal with natural resources. In addition to stocks, you might also want to add real estate — such as REITs — to your investment portfolio, or precious metals, such as gold and silver.

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