

What's inflation? And why do I need to consider it?



Series: Let's get back to basics
Complexity: **Beginner**

Inflation can be described as a rise in prices generally, which results in the gradual decrease in the value of our dollar.

It is a natural process in the economy and a steadily rising inflation rate is normally associated with a growing economy.

A good way to explain inflation is through the example to the right.

Why do I need to be aware of the effect of inflation?

When investing, it's important to consider inflation, as it can diminish the real value of your money over time.

example. inflation

Each morning, you buy a coffee for \$2.00. With a 5% per year inflation rate, in theory your coffee should cost \$2.10 the next year.

When looking at investment returns, you should consider 'real returns', which calculate your asset's value after inflation is taken into account.

Let's look at another example in the box below.

As investors, we all aim to make profitable returns. However, we need to consider the effects of inflation because it means our returns must keep up with the rate of inflation in order to achieve a positive real return over the long term.

example. real returns

The interest rate on your savings account currently pays 5% per annum (the 'nominal return'). If the annual inflation rate is currently at 3%, then the real return on your savings today would be 2% per year. That is, **nominal return - inflation = real return** OR $5\% - 3\% = 2\%$ real return. In other words, even though the nominal rate of return on your savings is 5%, the real value of your savings only increases by 2% over the year due to inflation.

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