

Inflation Quick Guide

Inflation plays a major role in an individual's finances, so it is vitally important that this is reflected in the advice process, and it is even more necessary when creating a long-term cashflow plan for your clients.

Inflation assumptions used in financial forecasting must be appropriate for the medium to long-term. Short-term deviations in inflation are normal and expected but headline grabbing published inflation rates represent the inflation that has already been experienced and is not a prediction of future inflation.

Therefore, periods of high or low published inflation will already be accounted for in the incomes and expenditures of your clients.

Stochastic Projections

Dynamic Planner forecasts real returns – therefore net of inflation – across its system, in the risk-reward trade-off shown for risk profiling, in investment portfolio reviews, recommendations and in cashflow planning.

The forecast is generated by a Monte Carlo scenario engine that generates thousands of possible real returns over 49 asset classes. As the returns are real to begin with, the various possibilities for inflation at different times are already factored in. It is therefore inappropriate to guess and factor in other numbers for inflation and apply them to the forecast.

As both the returns and the forecasts are real, you don't need to worry about inflation – it's already all accounted for. You can be confident that you are seeing the expected purchasing power of a client's assets at each point in time.

Further to this, the asset risk model and the Dynamic Planner risk profile asset allocations are stress tested to ensure that you can have confidence in our growth assumptions and plan confidently with your client. The stress testing performed in late 2020 focussed purely on inflation and the emergence from the global pandemic.

<https://www.dynamicplanner.com/stress-testing-dynamic-planners-asset-risk-model-plus-cash-flow-planning-with-confidence/>

Deterministic Projections

Moving away from investment returns and stochastic forecasts, we can also model known incomes and expenditures within our tools. These are modelled deterministically.

They will have a real return of zero and display as a flat line in cashflow if they are increasing in line with inflation. For the purposes of a deterministic income or expenditure, inflation is based on the Bank of England long-term inflationary target and is currently assumed to be 2.5% per annum. 2.5% was picked to allow 0.5% above the inflationary target for prudence, to ensure that we are presenting the most appropriate view to clients and advisers in the medium to long term.

Anything modelled stochastically, so anything that has investment returns, will be based on real returns and therefore a variable rate of inflation.

For the fixed cashflows that increases at price inflation, or 2.5%, it will appear flat within our modelling.

A rate lower than 2.5% will decrease over time.

A rate higher than 2.5% will increase over time.

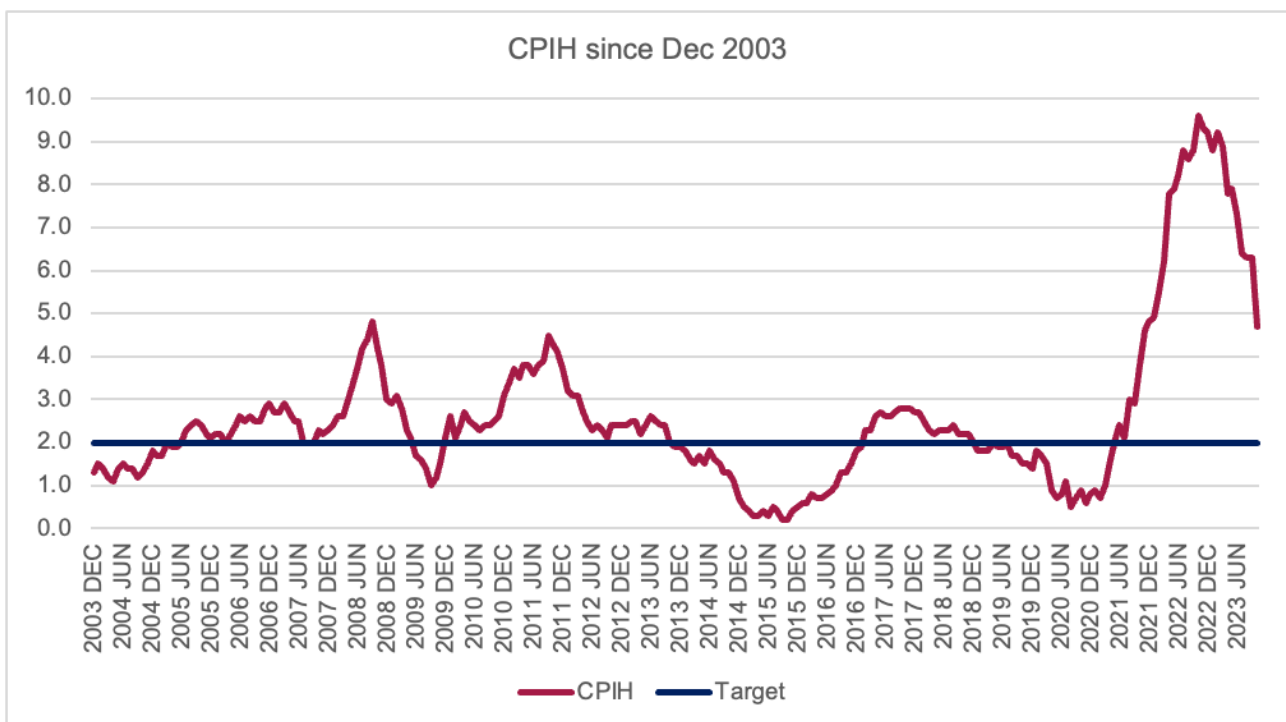
It's also worth noting that the FCA uses an inflation figure of 2.5% per annum under its COBS guidance.

Bank Of England Target Rate

In cash flow modelling it's important that we use an appropriate long-term assumption for inflation. Since the inflationary target was introduced in 1997, the government has committed to keeping inflation at a low and stable rate. The CPI target of 2% was introduced in 2003 and remains the focus of the Bank of England's Monetary Policy Committee.

For further information on the target, as well as commentary from the committee you can visit the Bank of England's website.

<https://www.bankofengland.co.uk/monetary-policy/inflation>





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