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Understanding Inflation and Its Impact on Investment Returns

Inflation quietly erodes purchasing power. It affects daily living costs, but more importantly, it determines the real—after-inflation—value of your investment returns. This report explains how nominal and real returns differ, demonstrates the erosion effect on cash, and shows why a diversified portfolio is essential to grow wealth in real terms.

1. Nominal vs Real Returns

• Nominal return is the headline percentage growth of an investment before inflation and tax.

• Real return adjusts the nominal return for inflation to reflect true purchasing power.

Formula for real return:

Real Return = (1 + Nominal Return) / (1 + Inflation Rate) − 1

Example: If nominal return = 8% and inflation = 6%, then:

Real Return = (1.08 / 1.06) − 1 = 1.89%

2. The Erosion of Cash Over Time

Even when cash earns interest, if that interest rate is below inflation, the purchasing power declines. The table below shows the real value of an initial R100,000 over time assuming 6% annual inflation.

Year	Inflation Assumption	Real Value of R100,000 (R)
0	—	100 000
1	6%	94 340
3	6%	83 970
5	6%	74 730
10	6%	55 840

In ten years at 6% inflation, the basket of goods that costs R100,000 today would cost about R179,000; cash that does not keep up loses purchasing power.

3. Comparing Cash, Bonds, and Equities (10-Year Illustrative Example)

Assumptions: 6% annual inflation; compounding nominal returns by asset class as shown.

Asset Class	Nominal Return p.a.	Inflation	Real Return p.a.	Value After 10 yrs (R100k start)	Real Value in Today's R
Cash / Savings	5%	6%	−0.9%	162 889	90 965
Government Bonds	8%	6%	1.9%	215 892	120 405
Equities (broad index)	11%	6%	4.7%	283 942	158 282
Balanced Portfolio	9%	6%	2.8%	236 736	131 919

Observation: Cash tends to lose ground in real terms; bonds may barely preserve purchasing power; equities and mixed portfolios have historically outpaced inflation over long horizons.

4. Diversification Calculation Example

Consider a portfolio: 30% equities (11% p.a.), 30% bonds (8% p.a.), 30% property (9% p.a.), 10% cash (5% p.a.).

Weighted nominal return = (0.3×11%) + (0.3×8%) + (0.3×9%) + (0.1×5%) = 8.7%

Real return with 6% inflation = (1.087 / 1.06) − 1 = 2.5%

Interpretation: While equities alone may produce higher long-term growth, the diversified mix provides smoother returns with inflation-adjusted growth.

5. Practical Steps to Protect Purchasing Power

• Assess results in real terms (nominal minus inflation), not only nominal.

• Avoid overexposure to cash; keep cash for liquidity and emergencies (typically 3–6 months' expenses).

• Blend asset classes—equities and property for growth; bonds for stability; cash for liquidity.

• Consider inflation-linked bonds or CPI+ funds where appropriate.

• Reinvest income to benefit from compounding.

• Review allocations and rebalance as conditions and goals change.

Conclusion

Inflation is inevitable, but its impact on your wealth is manageable with proper planning. Holding only cash virtually guarantees a decline in purchasing power over time. A disciplined, diversified portfolio is the foundation for maintaining and growing real wealth.

Contact us for a consultation and advice to inflation-proof your investments.

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