COMMON FOUNDATIONS

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The Inflation Dilemma

CAI on Inflation

Budgeting for inflation and return on investment are not necessarily standard elements of a reserve study. Some providers account for these variables; others do not. The Community Association Institute's GAP Guide *Reserve Funding & Reserve Investment Strategies* acknowledges both approaches as legitimate. Although the guide addresses a variety of investment strategies – far more than we can discuss here, it also states: *"Historically, the inflation rate has averaged approximately 4 percent per year, although it has been lower than this over the past few years."* True enough, except that as we see here, these averages do not address the unique needs of community associations. On the other hand, we all understand the time value of money. Using an inflation rate of 8% or more can have a staggering impact on predicted future costs and reserve requirements over 20 or 30 years. This only serves to underscore the importance of revisiting the reserve study on a regular and frequent basis to ensure that cost factors are being tracked as accurately as possible.

Inflation is something we've not paid much attention to for many years. Since the 1980s, inflation has averaged almost negligible amounts in most years. Furthermore, we've grown used to making investments that approximate or at least keep us ahead of inflation based on our rate of return. Those days may be over.

We hear it in the public discourse over the cost of living…whether it be from retirees disputing Cost of Living Adjustments (COLAs) or from working citizens who would like higher salary increases. The argument has been that government inflation indices (such as the Consumer Price Index, or CPI) are out of sync with what average Americans are facing. The problem is that the factors influencing inflation indices such as the CPI are diverging.

We've seen commodity prices increase in oil, gasoline, electricity, base metals, and grains while the value of assets such as housing and many consumer goods decreases. These are all factors that influence the CPI.

This "divergence" of inflation components may average out in the CPI, but it's hitting full force with select industries such as community associations. A better measure may be the Producer Price Index (PPI). A look at the latest Bureau of Labor Statistics (BLS) figures ending September 1 reveals the following increases in <u>just the past year</u>:

- Residential maintenance and repair: 11.5%
- Non-residential maintenance and repair: 15.1%

The figure for non-residential maintenance and repair applies to many multi-story condominium associations due to the nature of their complex maintenance and repair tasks.

The problem rears its ugly head when it comes to reserve accounts. Funds are collected ahead of time to meet the need of anticipated future capital expenditures. In the past we expected these funds to grow over time to help fund the future costs. Today's reality is that these funds <u>may</u> earn 1% annually with smart management. This leads to a declining real value of the reserve account, as inflation is eating away its true value.

The problem for many community associations is doubled since the members of

the association face the same problem. Retirees rely on Social Security and other entitlement programs that are indexed to government inflation figures, namely the CPI. This leads to a reduced ability of the members of the association to pay for an increasing target of reserve funds for their association into the future.

The question is: What do we do about it? One answer is to look at alternative means to manage your future inflation risks and to think seriously about risk management.

As an example, we recently spoke with a property manager about a reserve study for a property that's major asset is twelve miles of roads. Their reserve study will likely be heavily weighted towards the cost of asphalt paving in the future. If they are collecting reserve funds now to fund road replacements in the future, their normal response would be to invest these in some bank financial instruments such as CDs. If they look at their balances and future obligations in detail, they might ladder their CDs to obtain slightly higher interest rates.

Asphalt paving, however, has a strong correlation to oil prices. If the price of oil goes up, the material cost of asphalt typically follows. A strategy the board might consider (and we say *consider*, as there are risks involved and we are not investment advisors) is to invest a portion of their reserve funds in financial instruments that track the price of oil. Today it is much easier to do this type of investing through Exchange Traded Funds (ETFs) than in the past when it meant taking long positions in commodity futures and managing their contract terms. If the cost of oil goes up substantially in the future, the value of their investment and the cost of their capital projects go up, cancelling each other out depending on the levels invested. The reverse is true if the cost of oil goes down. But once again, we caution you to consult a trusted investment advisor before considering such an option.

There is obviously much more to discuss about taking the management of your reserve funds to this level. That is not the role of a reserve consultant. It is important to start the discussion, however, because the future dictates that we think "out of the box" in contrast to what we've done in the past, given the future that's been handed to us.

Note: This article was originally prepared by Phil Proctor, P.E., who is the Principal of Criterium-Proctor Engineers in Augusta, Georgia, an affiliate of Criterium Engineers. Criterium Engineers has been providing comprehensive building consulting and engineering services since 1957 and has 60 offices serving North America.

Inflation Index—Who Decides?

Because of the variation in measures, not all reserve studies consider inflation or the return on invested monies. However, acknowledging that these factors have a significant effect on the future value of your reserve account and the capital needs of your association, some allowance should generally be made. But, with the variety of inflation measures available, how do you pick the right one – CPI, PPI, or something else? There is no one correct answer. And we, as engineers, have no special insight into this question. We typically will ask you to obtain a desired value from your investment advisor or accountant. They are generally better able to determine which measure is most appropriate to your situation.

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