Inflation and Taxes Reduce Returns

The adverse effects of inflation and taxes on investment returns become especially pronounced over the long run. Comparing the returns of different asset classes both before and after inflation and taxes is helpful in understanding why it is so important to consider inflation and taxes when making long-term investment decisions.

This image illustrates the compound annual returns of three asset classes before and after considering the effects of inflation and taxes. Since 1926, inflation and taxes have dramatically reduced the returns of stocks, bonds, and cash.

Of the asset classes considered, stocks are the only asset class that provided significant growth. Government bonds, after factoring in both inflation and taxes, barely provided a positive return. Treasury bills, however, fared the worst—a return of –0.8% was produced.

If you wish to overcome the effects of inflation and taxes, you may want to consider a larger allocation to stocks. Another alternative, if you are able, is to consider tax-deferred investment vehicles.

Diversification does not eliminate the risk of experiencing investment losses. Stocks are not guaranteed and have been more volatile than other asset classes. Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than the other asset classes.

About the data

Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $120,000 in 2015 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. When realized, capital gains are calculated assuming the appropriate capital gains rates. The holding period for capital gains tax calculation is assumed to be five years for stocks, while government bonds are held until replaced in the index. No state income taxes are included.

Stocks are represented by the Ibbotson® Large Company Stock Index. Government bonds are represented by the 20-year U.S. government bond, cash by the 30-day U.S. Treasury bill, and inflation by the Consumer Price Index. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for transaction costs.