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Financial Planning and Wealth Management

PORTFOLIO STRATEGIES TO COUNTER INFLATION

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With high government spending and rising national debt, many people are asking how they can prepare for potentially higher inflation. There are two basic ways to address inflation uncertainty: hedging the immediate effects or earning a total return that outpaces inflation.

It may seem that everyone thinks inflation is coming and interest rates are bound to rise but few seem to acknowledge that asset prices already reflect the market's expectations about future inflation, given all available information. This is a large part of why many traditional hedges against inflation are selling for historically high prices.

Hedging vs. Total Return Strategies

Hedging involves choosing assets whose value tends to rise with inflation. Hedging can be an expensive endeavor so holding these assets may reduce the total return of a portfolio over time, even if the hedges help an investor keep up with rising prices in the short term.

In a total return strategy, an investor attempts to outpace inflation by holding assets that are expected to earn higher real (inflation-adjusted) returns over time rather than speculating on short term changes. This investor is willing to give up short-term inflation protection for an opportunity to grow real wealth.

Bottom line: Your broadly diversified portfolio includes a variety of assets which have inflation protection properties.

Stocks

As part of a long term total return approach to offsetting inflation, stocks have been a great choice. From 1926 through 2008, the total US stock market, as measured by the CRSP 1-10 Index, outpaced inflation by an average of 6.16% per year. There were no 20 year periods in which stocks failed to beat inflation. None. While that is no guarantee of future results, it is as good as a track record can be. We outlined some of the reasons for this great record (87% success rate averaging 7.24% above inflation over 10 year periods) in our commentary "Why Stocks Win" back in the depths of the financial crisis.

In short time periods, however, the record is chaotic. US market history since 1926 shows that annual stock returns are not correlated to inflation.

Bottom line: There are no guarantees of good results with stocks. Most people should have some stock investments, but few people are likely to be well served over their lifetime by a portfolio of 100% stocks.

Fixed Income (Bonds & CD's)

Higher inflation can hurt bondholders and CD owners in two ways—through falling market values triggered by rising interest rates and through erosion in the real value of interest payments and principal at maturity. This inflation exposure tends to impact the prices of long-term bonds more than those of short-term bonds, and investors can mitigate the effects of rising interest rates by holding shorter-term instruments.

When interest rates are climbing, a portfolio with shorter-term maturities enables an investor to more frequently roll over principal at a higher interest rate. This can help inflation-sensitive investors keep up with short-term inflation and enable total return investors to reduce portfolio volatility, which can lead to higher compounded returns and growth of real wealth.

Going too short with maturities, however, is usually a losing maneuver. “Why Stocks Win” pointed out that while 1 month T-bills (US government securities often used as a proxy for cash and money market funds) topped inflation about 2/3 of the time, they only topped inflation by an average of .32% pre-tax.

Bottom line: There are no guarantees of good results with bonds or CD’s. Most people should have some fixed income investments but few people are likely to be well served over their lifetime by a portfolio of 100% bonds.

Treasury Inflation-Protected Securities (TIPS)

Issued by the US government, TIPS are fixed income securities whose principal is adjusted to reflect changes in the Consumer Price Index (CPI). When the CPI rises, the principal increases, which results in higher interest payments.

TIPS are generally a good short-term inflation hedge since principal is adjusted for changes in the CPI. They are also a good portfolio diversifier for some long-term investors due to their negative correlation with equities and relatively low correlation with most types of fixed income assets. (Correlation refers to the extent two assets tend to increase or decrease together). However, because TIPS are so attractive as a guaranteed hedge against inflation, they are selling at historically high prices. Recently, a ten year TIP only guaranteed a yield .67% greater than inflation. However, if inflation is more than 2.51%, the TIP will provide a higher return than traditional treasury bonds.

Bottom line: There are no guarantees of good results with TIPS. Most people should have some TIPS investments but few people are likely to be well served over their lifetime by a portfolio of 100% TIPS.

Commodities

Commodity futures, as well as gold and oil, are perceived as effective inflation hedges on the belief that their returns are positively correlated with inflation. Much of this perception is a function of what happened in the 1970’s. A scientific examination of actual data suggests some commodities, like gold, are not well correlated to inflation at all. In August of 2010, the *Wall Street Journal* reported that Ibbotson and Associates calculated the correlation between gold and inflation since 1978 at a mere .08, meaning there was no direct relationship at all. Commodities are far more volatile than stocks. Conservative or skittish investors may find that adding these assets to a portfolio causes more stress from volatility than they can bear.

Investors should also consider the economic argument against holding commodities. Unlike stocks, commodity futures do not generate earnings or create business value. Unlike bonds, they offer no income. They are essentially a speculative bet in which there is a winner and loser at the end of each trade. Moreover, a broad-based stock portfolio already has significant commodity exposure through ownership of companies involved in energy, mining, agriculture, natural resources, and refined products.

Bottom line: There are no guarantees of good results with commodities. Most people already have exposure to the effects of changes to commodity prices through their stocks and bonds and should not speculate directly on commodities in their portfolios. Almost no one is likely to be well served over their lifetime by a portfolio of 100% commodities.

Summary

While the media has featured all sorts of financial experts calling for higher inflation and rising interest rates for several years now, diversified portfolios have performed well given the financial crisis and a weak economy. No risky or expensive speculation was required.

As we assess your exposure to a rising inflation scenario and form a strategy that reflects your financial goals and risk tolerance, we consider that:

- *Expected inflation is built into asset prices.* In our view, markets are not perfect but they do a great job of integrating all known information and adjusting prices very quickly to new information.
- *Hedging unexpected inflation has a cost*. Investments traditionally regarded as effective short-term inflation hedges have lower historical long term returns than stocks. Some, such as commodities, look expensive on a historical basis.
- *Volatility matters.* Evaluating assets solely on their ability to track inflation disregards the effect of volatility on returns and risk. Some assets that are positively correlated with inflation have large return variances, and adding these to a stock and bond portfolio may increase overall volatility.

Even with the prospect for higher inflation, our view holds that investors who take a total return approach with a broadly diversified portfolio are likely to be better served over time than those who choose to speculate on short term gyrations and buy assets based on correlation with inflation. There are no guarantees but by choosing assets expected to exceed inflation over the long-term and by maintaining broad diversification, investors can seek to grow real wealth and preserve the purchasing power of their dollars. No risky or expensive speculation is required, even if discipline and patience are.