Staying Ahead of Inflation

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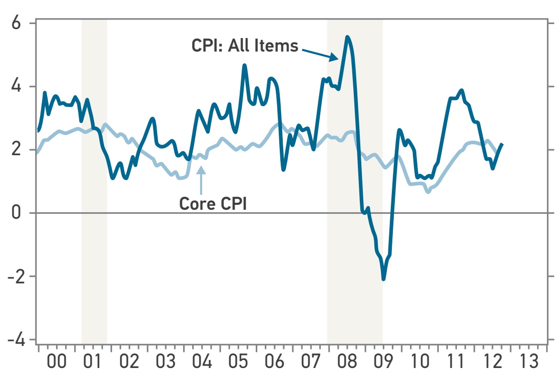
A discussion of some of the asset classes that can protect your portfolio from an eventual increase in inflation.

Introduction

Inflation has remained dormant since the worst of the financial crisis. The rate of change in the Consumer Price Index is no longer negative, as it was throughout much of 2009, but it is still running at an annualized rate below 2%. Investors should be cautious, however. The world's biggest central banks, including those in the United States, Europe, Japan, and China, are doing "whatever it takes" to keep their respective economies from slipping back into a recession. The Federal Reserve has taken such steps as holding interest rates at artificially low levels, initiating bond purchasing programs, and increasing spending on infrastructure. All of these measures are flooding the markets with stimulus and they are likely to have an inflationary impact at some point in the future.

Some inflation in our economy is seen as positive. The Federal Reserve has set a 2% target for inflation that, if met, would signify a healthy, growing economy. Unexpected and rapidly rising inflation, on the other hand, threatens investors' long-term objectives and erodes purchasing power. We believe that investors should begin looking at asset classes that can provide protection against inflation risk.

CPI-U: All Items: 1982-84=100
Y/Y %Change
CPI-U: All Items Less Food and Energy: 1982-84=100
Y/Y %Change[1]



Inflation Protection From Bonds

Typically, bonds are the worst performers in periods of rising inflation, but one security, Treasury Inflation Protected Securities (TIPS), created by the U.S. Treasury in 1997, will adjust its price upward in conjunction with increases in the Consumer Price Index. TIPS are issued with maturities between five and twenty years, pay relatively small nominal yields, and receive price adjustments based on semiannual changes in the CPI. Short-term TIPS returns tend to most closely track actual CPI inflation because of their lower duration and greater responsiveness to temporary, unexpected inflation changes. There is a trade-off for this inflation protection. A short-term TIPS fund recently announced by Vanguard will initially have a negative yield. Also, because a TIPS bond's semiannual inflation adjustments are considered taxable income by the IRS even though investors won't see any money until they sell the bond or it reaches maturity, some investors prefer to get TIPS exposure through a TIPS mutual fund or only hold TIPS in tax-deferred retirement accounts that allow investors to avoid tax complications.

Inflation Protection Through Traditional Equities

Despite popular thought that the stock market typically provides a good inflation hedge, studies have shown that there may be, in fact, a negative correlation between inflation and nominal stock market returns. Although

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the overall stock market may be a poor inflation hedge, companies in certain sectors may have very good inflation-hedging properties. For example, the pricing of raw material goods early in the chain of production (i.e. oil, fresh food) is more flexible than the pricing of processed goods or services. It seems that the individual consumer is still a powerful force in price setting. Sectors with superior inflation-hedging characteristics include basic materials (exploration or mining of metals, minerals, and other commodities), followed by the oil and gas and technology sectors. The technology sector is composed of companies that often create new, high-value-added products, which provides them with great pricing power.

Real Assets Including Commodities and Real Estate

As the demand for goods and services increases, the price of those goods and services usually rises too, as well as the price of the commodities used to produce those goods and services. The Dow Jones-UBS Commodities Index divides commodities into five classifications: energy, agriculture, precious metals, industrial metals, and livestock. The prices of individual commodities can be very volatile and unpredictable, so we recommend holding a diversified portfolio of commodities in the form of a mutual fund, exchange traded fund (ETF) or exchange traded note (ETN).

AVERAGE ANNUALIZED RETURNS IN HIGH-INFLATION SEMESTERS[2]	
CPI	6.1%
Commodities	19.2%
Equity REITs	12.3%

A long list of variables can influence the price of real estate including supply and demand, geography, type (commercial, residential, timberland, etc.), interest rates, and simply cash flow. With the exception of geography, these variables all have some relationship with inflation. Consider cash flow, for example. The fact that the majority of lease rates rise from contractual rental-rate increases at or above that of the CPI (such as in lodging, self-storage, and apartments) appears to support the argument for real estate as an inflation hedge. This cash-flow increase should apply upward pressure on real estate values.

A broadly diversified portfolio of Real Estate Investment Trusts (REITS) in the form of a mutual fund or ETF can provide an attractive yield and a hedge against inflation, and it also is an investment that has a low correlation to traditional asset classes such as stocks and bonds.

Assets That Sustain the Most Downward Pressure in an Inflationary Environment

Long-dated, low coupon bonds would experience significant price declines in a period of rising inflation. For example, buyers of today's ten-year Treasury bond will receive a 1.625% coupon over ten years resulting in a duration of 9 years (duration is the weighted average time until cash flows are received, measured in years). If interest rates for similar bonds rise by 2%, the price of the original bond would decline by approximately 18%. A ten-year bond with a 5% coupon would have more cash flow over the life of the bond and therefore more of a cushion against inflation. This hypothetical 5% bond has a 6-year duration and would decline by approximately 12% if interest rates rise immediately by 2%. An investor would, of course, have to pay a premium for the higher coupon interest.

Other assets that would suffer from rapidly rising inflation include equities, or equity-like investments, in companies that do not have the ability to pass along price increases. This would include companies in the consumer products industry as well as financial companies and utilities.

While none of these asset classes offers a perfect hedge against inflation, we believe that they will provide some needed stability in client accounts when inflationary pressures eventually occur.

[1] *Strategas.*
[2] *Brad Case et al., University of Pennsylvania, 2011.*