The Money Advisor Group

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Advisor Views

A feature from **The Money Advisor Group.** *Advisor Views* offers timely investment news and market updates designed to keep you informed, while enhancing your overall investment experience.

Managing Inflation Risk

As the capital markets have improved, more investors have shifted their concern from weathering the financial crisis to anticipating the inflationary effects of rising federal spending and debt. Many people may be asking how they can prepare for potentially higher inflation. This article explores two basic ways to address inflation uncertainty and highlights asset groups that may prove useful.

Hedging vs. Total Return Strategies

Investors can prepare for unexpected inflation by following one of two basic strategies—hedging the immediate effects of inflation, or earning a total return that outpaces inflation over time.

Hedging involves choosing assets whose value tends to rise with inflation. This positive correlation with inflation can help an investor keep up with rising consumer prices, at least over the short term. (Correlation refers to the co-movement of asset returns. When two assets are positively correlated, their returns tend to move together; when negatively correlated, their returns are dissimilar.)

Candidates for hedging may include retirees, fixed income investors, and others who would experience a diminished living standard during periods of inflation. These investors are likely willing to forfeit long-term growth potential for more immediate inflation protection.

In a total return strategy, an investor attempts to outpace inflation by holding assets that are expected to earn higher real (inflation-adjusted) returns. This investor is willing to give up short-term inflation protection for an opportunity to grow real wealth. Younger investors are typically well suited for this strategy because they have many years until retirement and expect their earnings to grow at a faster pace than the inflation rate. As they save and invest for the future, they can accept more risk through greater exposure to higher-return assets, such as stocks.

To insulate a portfolio from unexpected inflation risk, both strategies may employ some combination of stocks, short-term fixed income, and Treasury Inflation-Protected Securities (TIPS). Let's consider each of these:

Stocks

Equity securities have provided a positive inflation-adjusted return over the long term. From 1926 through 2011, the total US stock market, as measured by the CRSP 1-10 Index, outpaced inflation by an average of 6.57% per year.[1] To achieve this higher expected real return in stocks, however, an investor had to accept more risk, as measured by greater volatility in returns, and endure periods when stocks did not outpace inflation. As a result, stocks may be less effective for hedging short-term inflation, and more suitable for investors who want to beat long-term inflation by earning a higher total return.

Fixed Income (Bonds)

Higher inflation can hurt bondholders in two ways—through falling bond market values triggered by rising interest rates, and through an erosion of the purchasing power of interest payments and the principal at maturity. Inflation tends to impact the prices of long-term bonds more than those of short-term bonds, so investors looking to mitigate the effects of rising interest rates may benefit by holding shorter-term instruments.

Short-term bonds can benefit investors in a number of ways: When interest rates are climbing, a portfolio with shorter 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.

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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. At maturity, an investor receives the greater of the inflation-adjusted or original principal. The inflation provision enables TIPS to preserve real purchasing power and hedge against unexpected inflation.

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. TIPS were introduced in 1997, so these correlations are based on a relatively short sample period.

Keep in mind, however, that TIPS prices also have been affected by changes in real interest rates, so TIPS may not track inflation one-to-one in the short term or over longer periods of time. In fact, TIPS can lose market value if real interest rates increase.

As you assess your portfolio in light of a high-inflation scenario, and form a strategy that reflects your financial goals and risk tolerance, consider that:

- *Expected inflation is built into asset prices*. In our view, markets efficiently integrate all known information into prices. Thus, current prices already reflect expectations of future inflation. Only unexpected news will affect the inflation outlook.
- *Hedging unexpected inflation has a cost*. Investments traditionally regarded as effective short-term inflation hedges have lower historical returns than stocks—and some have much higher volatility.
- *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 may increase overall volatility.

Even with the prospect for higher inflation, investors who take a total return approach may be better served than those who choose assets based on correlation with the CPI. By choosing assets with higher expected long-term returns and maintaining broad diversification, investors can seek to grow real wealth and preserve the purchasing power of their dollars.

Endnotes

[1] Real return calculation: (1+CRSP 1-10 Index return)/(1 + US CPI)-1. The CRSP 1-10 Index is a market capitalization weighted index of all stocks listed on the NYSE, Amex, NASDAQ, and NYSE Arca stock exchanges. CRSP data provided by the Center for Research in Security Prices, University of Chicago.