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Inflation's Shadow: Investment Offsets and Their Risks

by Laurie Budgar

It's hard to turn on the news without hearing about skyrocketing oil prices or rising food costs. Yet government statistics say core inflation is minimal. It's a harrowing time for financial planners, who are trying to determine the extent to which they need to protect their clients' portfolios from inflation and how to do so without taking on too much additional risk.

The Financial Planning Association's proprietary survey[1] of more than 400 advisers in February 2011 finds that most anticipate inflation rates of about 2.6 percent in the coming year. The Congressional Budget Office, however, predicts only 1.3 percent inflation in 2011,[2] and similar rates until about 2015, when it could rise to 1.9 percent. The Consumer Price Index (CPI) has reflected an even more modest rate—around 1.1 for most of 2010—until it nearly doubled in February to 2.1 percent over the past 12 months. Ignoring food and fuel costs, the CPI is a much tamer 1.1 percent.[3]

An Environment Ripe for Inflation?

On a global scale, population growth is explosive, having doubled in the last 50 years. In the 49 least-developed countries, the growth rate is nearly twice that of the rest of the developing world.[4] Meanwhile, the emerging economies of the BRIC nations—Brazil, Russia, India, and China—are moving toward modernization. With greater disposable income, they are stepping up demand for more and better food, shelter, and clothing—and the agricultural and industrial commodities needed to produce those goods. And none of those commodities can be produced without oil.

As a result, the price of oil was on its way up even before the political events that gripped the Middle East and North Africa occurred earlier this year. As of mid-March, crude oil was hovering between $100 and $105 per barrel. Any additional crisis—such as the fall of the government of a major oil producer—could drive prices even higher.

But unlike inflationary periods, we're not seeing corresponding increases in housing, jobs, or wages, despite the fact that the federal government has employed the kind of loose monetary policy that typically leads to core inflation. For example, the United States has a $14 trillion debt, and the Federal Reserve has printed more than $2 trillion in new money since 2008[5] and reduced its overnight rate essentially to zero. But the banks, once bitten by the credit crisis, are now twice shy when it comes to lending, keeping inflation in check. When they do resume lending and the hordes of money start circulating throughout the economy, it's more likely that the U.S. dollar will become significantly devalued.

For now, the countervailing forces between deflation in labor rates and inflation in industrial and agricultural commodities is keeping aggregate inflation low, says Ron Altman, senior vice president and senior portfolio manager at MD Sass in New York City. "In this economic period, the inflation you want to hedge against is industrial and agricultural commodities; these are the two long-term shortages in the world. The inflation you don't want to hedge against is labor inflation," Altman says.

While he predicts a very benign overall inflationary environment for the next 10 to 15 years, others aren't so optimistic. Kent Smetters, Ph.D., Boettner professor at The Wharton School of the University of Pennsylvania, believes inflation will remain low for a few years and then climb sharply because of the enormous budget crunch we'll be facing. Responses from FPA members in the February survey fall in the middle: they expect average annual inflation will be 3.45 percent over the next two years and 4.24 percent over the next five.

Most financial planners aren't waiting to find out who's right. Sixty-one percent of FPA survey respondents said they've re-evaluated their asset allocation strategies this year. Of those, 58 percent said they did so, at least in part, because of anticipated or existing changes in inflation.

The Nature of the Beast

It's commonly understood that inflation erodes purchasing power, but the extent of that depletion is often underestimated. According to Smetters, each point of inflation will cause an approximate 20 percent decrease in purchasing power over the next 25 years.

The erosion of purchasing power may be particularly apparent when people invest in bonds, only to find that prices fall as interest rates rise, devaluing their principal. Naturally, many planners move away from bonds and toward stocks when significant inflation is anticipated. In fact, of those advisers who have recently re-evaluated their asset allocation strategy to accommodate existing or anticipated changes in inflation, 68 percent say their inflation-protection strategies for portfolios include increasing their clients' allocation to equities, and 61 percent report decreasing exposure to bonds.

In addition to general strategies, the FPA survey asked all respondents about particular investment vehicles to hedge against inflation. The most popular securities chosen (at about 57 percent each) were commodities and Treasury Inflation-Protected Securities (TIPS); while TIPS are widely considered the safest investment against inflation, commodities are among the riskiest. Equities came in a close third at 56 percent, and 46 percent of planners use real estate investment trusts as an inflation hedge. Below we take a look at each of these, as well as some other popular investment vehicles, to provide a refresher on the options for investing client assets during periods of inflationary uncertainty as well as to illuminate which asset classes your planning peers are keeping an eye on.

Commodities

Traditionally, investors flock to commodities during times of inflation. It's partly emotional—people want a physical asset they

can eat, live in, or stash under the bed. It's also partly mathematical: commodities have had a 0.58 correlation to inflation over the past 10 years, the highest of any asset class, according to research by Bloomberg and Invesco PowerShares.[6]

Smetters cautions that correlation numbers can be misleading. When correlations are calculated, he explains, the formula takes away the average performance of each series and only looks at whether the two series move together. "It's true that commodities and CPI move together over time, but it's also true that CPI almost always has a larger average than the commodities' return. They don't keep up with CPI; it's the only major asset class that historically has underperformed CPI, even though they're more correlated." In other words, correlation doesn't tell the whole story—returns do.

But a 2009 analysis from the International Monetary Fund (IMF) found that in the first two years after an inflation shock, commodities fared better than any other inflation hedge.[7] And because they have low correlation with other asset classes, they're a good way to diversify a portfolio. But they're also incredibly volatile. Choosing the correct commodity—and the best way to invest in it—is the tricky part.

Industrial and agricultural commodities, such as copper, iron, steel, timber, soybeans, wheat, and pork, are poised to do well, considering the swelling infrastructure and dietary needs of developing nations. Other commodities, such as gold, are already too popular, according to many experts. But with China and other countries moving away from the dollar as the sole international trade and reserve currency, gold could surge from its current all-time high (as of mid-March) of more than $1,400 to as much as $5,000, some insiders are speculating. But gold is exactly that: speculative. It has no industrial uses and doesn't pay dividends.

"The use of gold is to stick it under the mattress and make jewelry out of it," Altman says. "Sure, a lot of people in the developing world, whether it's Russia or India, like to buy jewelry. But I don't want to base my investment strategy on their continued desire to buy things made out of gold."

The high prices for oil and other energy resources are attracting investors as well. The peak-oil crowd believes the scarcity of the black gold will drive prices ever higher, until we run out of it. Most experts, however, believe demand for oil will eventually drop, taking prices down with it. As evidence, they cite the increasing urgency with which automobile manufacturers are developing electric cars as well as consumers' tendency to cut back on consumption when the price hits a certain psychological barrier. For now, though, many individual investors are seduced by the headline prices.

But it's difficult, if not impossible, for the average investor to directly own oil—or, for that matter, most commodities. "If you're Exxon, you may be able to somehow get spot oil because you have an oil tanker you can store it in, but the average financial adviser just can't do that," says Ed McRedmond, senior vice president of institutional and portfolio strategies at Invesco PowerShares Capital Management in Chicago. As a result, buying futures on exchange-traded funds has become one of the more popular vehicles for gaining exposure to commodities. It's not for the faint of heart, though. Commodity prices notoriously overreact to small changes in supply and demand. And if a natural disaster strikes—think of the Japanese tsunami in March—supply chains may be interrupted for an unknown period. Mining risks, political turmoil, and numerous other factors all play into the price of commodities. What's more, investors may be disillusioned when their ETF or other investment vehicle doesn't deliver the headline returns. "It's not a direct correlation," McRedmond says, "because you're not accounting for storage costs that are going to eat away from the spot return or for [the structure of] the futures market."

ETFs roll their contracts on a predetermined schedule, so that as one month's contract wraps up, the fund automatically buys the next, regardless of price. If the market is in contango—the price of each futures contract is more expensive than the one just sold—investors stand to lose money. They also incur trading costs 12 times a year.

An alternative is an ETF that uses optimum yield methodology. Rather than rolling every month, the PowerShares DB Oil Fund (DBO) ETF, for example, uses an index that looks out 12 months over the futures curve of the commodity and mathematically calculates the optimal place to roll. "It's meant to maximize positive roll yield in backwardated markets and minimize negative roll yield in contangoed markets," McRedmond says.

That doesn't solve the risk of a potential liquidation, however. "If everybody decides to get out at once, the ETF has to sell whatever it owns, bringing down the price, and it starts to feed on itself. You can get a waterfall in an ETF much faster than you would in a stock," Altman says.

Equities

Businesses usually do well during periods of commodity inflation—or at least they seem to. They raise the prices on their widgets to account for the higher costs of materials, and post higher earnings (even if they are artificially inflated by the dollar's lower value). And in most economic recoveries, hiring accelerates, often at lower salaries than pre-recession levels. But because 19.7 percent of consumers are still either unemployed or underemployed[8] in today's economy, they're unable or unwilling to pay those higher prices. Companies either need to make up the margin somewhere else, or show a loss on their balance sheets.

Packaged food and restaurant companies would appear exempt from this predicament. After all, consumers have already absorbed higher food prices and, if the USDA is right, they will continue to do so for at least the remainder of this year. Likewise, companies directly or indirectly involved in agricultural or other commodities—for example, those that manufacture farm and mining machinery—should also do well.

For these reasons, many planners like equities in emerging markets, which tend to be heavily commodity-based. As with domestic commodities, these can be risky, particularly because the markets aren't as mature or liquid. But as they develop greater infrastructure over the long term, they may do quite well.

"Although most advisers still recommend portfolios with a significant 'home bias,' the best allocation involves much more international exposure," Smetters says. "It is reasonable that emerging markets would reach up to 15 percent of one's portfolio." And, Smetters says, emerging markets offer a lot more opportunities than just commodities, with a growing consumer base. "The key is to look for developing economies with stable fiscal outlooks, with low debt-to-GDP ratios, over the next 30 years," he says. While he still believes in the BRIC economies, Smetters says there are other bargains to be found in Latin America and Eastern Europe.

Bonds

Traditional fixed-rate bonds are a surefire way to lose money when interest rates rise. But various alternative bond products can actually defend portfolios against inflation.

Inflation-Indexed Bonds. More than 34 percent of FPA planners report using inflation-indexed bonds to help their clients' principal retain its value; 57 percent specifically point to TIPS.

- **TIPS.** Treasury Inflation-Protected Securities (TIPS) offer a built-in hedge. As the CPI climbs, so does the principal, so any interest earned is on an inflation-adjusted investment. Because they're backed by the U.S. government, they're widely seen as the lowest-risk method for protecting an investment. "People aren't going to retire on the income from TIPS," Altman says. "They're just not going to lose their principal." Investors must pay tax on the interest and on inflation adjustments to the principal at the time it's received, so it's often a wise move to put these inside a tax-protected retirement account. The only risk with TIPS is if buyer confidence in the U.S. government's ability to back the bonds wanes so much that a sell-off ensues.
- **I Bonds.** Also issued by the Treasury, these are a hybrid of fixed-rate and interest-protected bonds, and taxes are deferred until maturity. Interest rates are often quite low, but investors will never lose their principal. The government limits the amount of I Bonds an individual investor may purchase to $5,000 in paper bonds and $5,000 in electronic bonds per year.

Floating-Rate Notes. Unlike traditional bonds, whose value declines as rates rise during inflation, floating-rate bonds adjust their interest rates every 30 to 90 days to match the prevailing LIBOR rate, the rate banks charge each other for short-term loans—a loan structure not unlike an adjustable-rate mortgage. Floating-rate notes are most commonly accessed through mutual funds, which essentially offer investors an opportunity to own fractions of loans banks make to companies. They carry some risk, however, as the loans are often made to below-investment-grade companies.

High-Yield Bonds. Also known as junk bonds, these are attractive to investors willing to bet that the higher interest rates they carry offset the greater credit risk of the companies issuing them. And in this economy, when companies aren't able to raise prices to compensate for declining margins, junk bonds may carry a higher risk than usual. Still, FPA's research shows that at least 27 percent of planners include these as inflation hedges in their clients' portfolios.

Zero-Coupon Bonds. Zeros don't pay any interest until maturity. But investors can buy them at a deep discount and get the full face value when the bonds mature—the difference between the price paid and the face value representing the interest. If interest rates go high enough, these could enable investors to reap a nice return off a very small investment and pay for a planned expense, such as a child's college education. So far, though, we haven't seen interest rates that would make them truly attractive. Plus, investors still have to pay taxes on the "phantom interest" that accrues even though they may not pocket it for 10 years or more. As with all bonds, the credit-worthiness of the issuer can increase or decrease the risk of the investment. And if investors need to sell them before maturity, they lose significant value.

Real Estate

Historically, real estate has performed well during inflationary cycles because lessors can raise rents over time. But it's a long-term play. Commercial real estate, at least, relies on an expanding job market to drive demand, so its growth might be limited for the foreseeable future, at least in the United States. On the other hand, it's a real asset, currently available at fire-sale prices, and will probably do well once the job market rebounds and when credit becomes more readily available.

Farmland has been hot lately, thanks to the high prices growers are getting for soybeans, corn, wheat, and other agricultural commodities. Even this carries additional risks, however: "You can buy a farm and lease the land to a farmer and right now you can get a good return, but that farmer isn't going to sign onto a 20- or 30-year lease, so you need to keep renewing it," Altman says.

Most investors who don't have access to large amounts of capital will choose to buy real estate through real estate investment trusts (REITs), which explains why more than 45 percent of advisers use them as inflation hedges, according to FPA research. McRedmond notes that funds with a heavier weighting toward small and mid-cap REITS tend to have the highest dividend yields. "If someone wanted very broad exposure to the U.S. REIT market, it may make sense to mix and match one of the larger REIT names out there with a REIT that is more focused on small and mid-cap."

The Long and Short of It

If inflation goes either higher or longer than expected, should your investment strategies change? A 2009 IMF working paper[9] finds that it is difficult for a long-term strategic asset allocation to protect against inflation surprises with traditional asset classes. Tactical asset allocation, however, can help hedge inflation by weighting a portfolio more toward commodities and away from bonds ex post inflation shocks, but then longer term, as the hedging properties of commodities lessen, switching back toward bonds. Equities, the authors say, particularly for those not applying a tactical approach, should be held for as long an investment horizon as possible to average out the effects of inflation cycles.

In addition, a 2009 paper by Marie Brière and Ombretta Signori at Amundi Asset Management[10] suggests that macroeconomic volatility and investing horizon should influence inflation-hedging decisions. For investors just wishing to see their portfolios keep up with inflation (what they call a "safety-first" investor with a pure inflation target), the authors find that in a volatile regime—high government debt, large oil shocks, and extreme swings in GDP growth—safety-first investors should mainly stick to cash for short time horizons, and increase allocations to inflation-linked bonds, equities, commodities, and real estate for longer horizons. In a stable economic environment, the authors find cash is still the best bet for short horizons, but an increase in nominal bonds, and to a lesser extent commodities and equities, will help protect portfolios against inflation for longer horizons. For investors seeking real returns above inflation, and assuming longer horizons, the authors suggest volatile regimes call for greater allocation to commodities and equities, and in a stable environment, commodities.

David Nawrocki and Harold Evensky, in their 2003 Journal of Financial Planning article,[11] looked at data from 1951 to 1998 and found that the degree of inflation matters. When inflation is below 4 percent, stocks seem to provide the best return. Between 4 and 8 percent, it's best to be invested in intermediate bonds. From 8 to 12 percent, T-bills perform best, and above 12 percent, they recommend a return to stocks.

What's Next

In 2008 and 2009, when almost all asset classes took a beating, "everybody fled toward what they believed were the safest things out there," like gold and T-bills, McRedmond says. "You'll have those black swan periods, and it hurts when they happen." Nevertheless, he emphasizes that diversification is still important. "Over the long term, history shows it has worked, so don't abandon that philosophy."

At the same time, the idea of "set it and forget it" hasn't worked over the past decade. Even relying on a mechanical schedule for rebalancing may not be the best idea when world events are so tumultuous. "In the past, most people used some kind of optimizer or Monte Carlo simulator, but the inputs are based on historical returns. Today, for long-term bonds, U.S. Treasuries—with rates as low as they are, it's almost mathematically impossible you could get that same historical return."

So, in the presence of uncertainty about inflationary movements to come, it doesn't hurt to remember the fundamentals and not lose sight of what is within your clients' control:

- Price matters. Whether it's a house, stocks, bonds, or whatever the pundits are saying is the can't-miss investment, "be mindful of the valuations and make adjustments accordingly," McRedmond suggests.
- Price doesn't tell the whole story. If you're investing in commodities, help your clients understand why they may not be getting the headline price they hear on the news.
- Think outside the office. One of the most overlooked investment vehicles doesn't involve a brokerage. Advise your clients to prepay expenses while prices are still low—or, at least, lower than those to come.

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