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How to Cope with Inflation

Alan Werba, CPA, CFP®
Managing Member

Aaron Rubin, JD, CPA, CFP®
Investment Advisor

3055 Olin Ave., Suite 2000
San Jose, CA 95128

408 260-3109

The risk of high future inflation may be one of the most important risk factors individual investors will face in their investment lifetimes. In the United States, inflation measured by the Consumer Price Index has averaged approximately 3% per year since 1926. However, the inflation rate has varied greatly over time, ranging from deflationary (negative inflation) periods in the 1930s to double-digit inflation during parts of the 1970s.

The challenge facing individual investors is how to protect themselves against unexpected inflation without over-exposing themselves to the many other risk factors they may face in building and protecting their wealth. This involves a process of balancing various risk factors that may affect a portfolio's expected return and uncertainty.

Risk factors that typically weigh on the investor's mind include interest rate risk, which is the possibility that once an investment tied to interest rates (e.g., a bond) is purchased the interest rate will go up, and the principal in the new investment will decrease in value. Reinvestment risk, or the issue of having to find a replacement for a matured bond or CD, can also be problematic. Also investors fear movements of securities prices on the whole, which is often referred to as market risk. There are many other risks to consider before investing, but let's focus on inflation risk.

When thinking about inflation risk, it is important to acknowledge that current stock market prices already reflect buyers' and sellers' expectations of future inflation, given currently available information. For example, when inflation expectations are high we normally see high yields in fixed income markets, while the opposite and times of low inflationary expectations. It is new and unexpected information that causes changes in inflationary expectations, which quickly filters through market prices. This is what investors need to manage.

For long-term investors, it is important to hedge inflation by seeking a total investment return that outpaces inflation over longer periods. Many consider equities to be the most effective asset class in attempting to serve this purpose. Results vary depending on the time period and data series used, but historically, equities have generally outperformed inflation by several percentage points or more over the longer term.[1] Therefore, investors with a long time horizon may be well served to hold a healthy percentage of their investments in a diversified portfolio of equities.

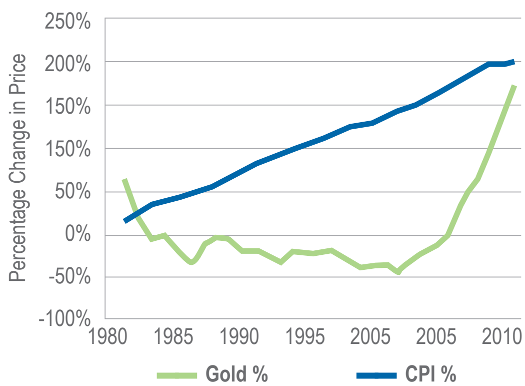
In the short run however, equities can deliver negative returns relative to inflation. Choosing to hold assets whose values tends to be highly correlated with inflation in the short run can help offset this risk. (Correlation refers to the co-movement of returns; assets that are highly correlated tend to move together.)

One of the more effective asset classes at hedging immediate inflation risk is short-term fixed income. Examples include money market funds, certificates of deposit, U.S. treasury bills and notes, and short-term, high-quality corporate debt. These types of assets have lower expected returns than equities, so there is a trade-off between immediate inflation protection and long-term growth potential.[2] Long-term bonds may not be good for hedging immediate inflation risk because of their high price volatility. Inflation can hurt long-term bondholders through falling market prices triggered by rising interest rates, as well as through the erosion of the real value of interest payments and principal at maturity.

There is an inverse relationship between risk as measured by standard deviation, and return.[3] But the risk gets disproportionally high, as the duration of bonds gets past the five year mark.[4] With insufficient compensation for the additional risk, investors need to think twice before holding longer term bonds. Additionally, certain asset classes such as gold[5] or oil that are traditionally considered good inflation hedges may not be. Many commodities have much higher price volatility than inflation, which can reduce their hedging benefit, and their long-run expected returns may only be roughly equal to inflation (unlike stocks that have significantly higher expected returns than inflation).

The chart below demonstrates how poorly gold tracked inflation from 1980 through 2010. While inflation steadily rose during these years, gold decreased in value then stayed dormant until recently, when it spiked, and almost caught up to inflation for the thirty year period. In fact, gold's price has only a 19% correlation with the consumer price index, and a 10% inverse correlation with the U.S. dollar.[6] This is to say, more often than not, when the value of U.S. dollar rises, the price of gold falls. This is not to say that a rising U.S. dollar causes gold prices to fall or vice versa, but that there is no evidence to support gold as a good inflation hedge.

Gold vs. Inflation



Source: Bureau of Labor Statistics & OnlyGold.Com.

The balance an investor chooses between equities and short-term fixed income depends upon a number of factors that are beyond the scope of this article. Part of the decision will be influenced by the degree to which one wants to hedge against the threat of near-term inflation at the cost of reduced long-term returns.

In general, younger investors may be attracted to portfolios with a higher percentage of equities, giving them potential for higher returns and greater protection against long-term inflation (but also greater volatility and uncertainty). Investors closer to retirement, or in retirement often prefer larger percentages of fixed income as their investment time horizon is shorter, risk tolerance is lower, and their need to hedge immediate inflation is greater.

Remember the following as you evaluate inflation risk:

- Assets that are highly correlated with inflation better hedge immediate inflation risk
- Expected inflation is already built into asset prices by market participants
- Hedging immediate inflation reduces long-term expected returns
- Inflation may be one of the most important risks you face
- Asset class diversification is important for any portfolio

If you have any questions about inflation, or how you are protected from inflation in your portfolio please call us at 408.260.3138, or e-mail us at arubin@werbarubin.com.

[1] Dimensional Fund Advisors, Matrix Book 2010.
[2] Ibid.
[3] *Structured Investing*, P. 11, Loring Ward 2010. See http://werbarubin.com/adPdfs/SI_Brochure_Werba_Rubin.pdf
[4] Ibid.
[5] Gold's Inflated Expectations, WSJ, January 19, 2011.
[6] Ibid.