

Inflation: What We're Thinking

Most of us are concerned about **excessive** inflation. We worry that all the money pumped into the economy in response to The Great Recession creates too many dollars chasing too few goods. Excessive inflation is a possibility but not a certainty. Naturally, the Federal Reserve hopes to return to more typical inflation of 2% to 3% and maintain that for the long term. For most of 2008 and 2009, there was low or no inflation. And, until the job market recovers, there probably won't be excessive inflation.

This article doesn't, and can't, answer the question of whether there will be excessive inflation. Instead this article addresses how your portfolio is protected if excessive inflation becomes a reality and explains the research, thinking and analysis we have been conducting on this subject.

Do you have part of your portfolio in short-term, high-quality bonds? For clients of RCG such bonds could include: the DFA One Year, Two Year and Five Year Fixed Income Funds, the Vanguard Short-Term Tax-Exempt Bond Fund, the Vanguard Short Term Bond Index Fund. All of these funds held up very well during the recent market crash. Because of their characteristics, they keep up with inflation and all indications are that they would keep up with excessive inflation with only a minimal loss of principal. The durations of these funds can vary from three months to five years. As an example, if a fund had a duration of one year and interest rates went up 3% in one year, then the fund would lose 3% of principal value.

If you do not have a portion of your RCG portfolio in fixed income, then you are probably someone who is still working and still accumulating investment assets. Wages can increase with inflation. The stock market can also increase with inflation. Neither of these outcomes provides a known level of assurance. So, if it is important to you at this point in your investment plan to protect against excessive inflation, then you should consider a meaningful allocation to short-term, high-quality fixed income as the best and most predictable protection. There is no free lunch, though. Any hedge against excessive inflation is likely to diminish overall portfolio return, both the nominal (stated) return and the real return (the return that exceeds inflation).

What about TIPS (Treasury Inflation Protected Securities)? We have explored this option extensively since TIPS were introduced in 1998 and again recently. They are surprisingly volatile and have not been tested in an environment of excessive inflation. They have negative tax attributes and thus are best held only in a tax-deferred account. We continue to be both pessimistic and uncertain of their value and therefore exclude them from our selection of desirable components in a well-diversified portfolio.

Besides inflation, a related concern is devaluation of the US dollar. You have two forms of protection in the equity portion of your portfolio that would mitigate the decline of the dollar. First, you have a meaningful allocation to international stocks. These international

stocks are not hedged for currency. Thus, when the US dollar declines, the foreign investment increases in value. In addition, many of the US companies in your portfolio are doing business internationally. A weak dollar allows them to sell more goods. If these US companies also have places of business overseas, they may benefit from selling goods in that currency.

We explored other options such as investment grade bond funds, selectively hedged international funds and high-yield funds as possible ways to earn a higher yield and protect against excessive inflation. But, all were systematically rejected because of their potential downside risks, or because they are new investment vehicles and the risks are undeterminable or too uncertain. Gold is also not a solution for high inflation. [We will have an article soon separately addressing gold.]

As always, we are available to discuss your specific portfolio allocation, changes to your life circumstances and possible changes to your investment plan.

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and investment management firm in Florida.*



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