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Building a Cushion Into Investments for When Inflation Returns

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As the American government continues to pump money into the economy, many investors have started to worry that inflation is inevitable.

Most economists don't expect inflation to arrive anytime soon. But nobody really knows when it will appear or how corrosive its effects will be. In the meantime, financial planners are suggesting that investors make sure that their portfolios are well positioned to withstand any impact on their hard-earned money — before it's too late.

"There are a lot of people who are worried about rising deficits and the prospect of a falling dollar, and all of these things will put upward pressure on inflation," said Alan Gayle, senior investment strategist at RidgeWorth Investments. "We don't see inflation as a problem this year and even perhaps for 2010, but it is a factor that investors should try and incorporate in their portfolios as they go forward."

That doesn't mean making a radical overhaul to your investment portfolio, unless, of course, it wasn't well diversified to begin with — or if all of your money is sitting in cash or low-yielding Treasuries with no long-term plan. (If that's the case, you may want to seek professional advice.) What many financial planners are recommending, however, is incorporating some classic inflation hedges — some inflation-protected securities, maybe, or some commodities, while making sure your fixed-income investments have relatively short maturities.

For the short term, investment experts agree, deflation is more probable, with unemployment still climbing and the economy still mired in a recession. There's talk of green shoots, but most everyone agrees that an earnest recovery is a long way off.

Still, inflation can quietly sneak up on you, and at that point it will be more expensive — or less effective — to get the inflation protection you need. It's especially rough on people who live on fixed incomes, notably retirees, many of whom have already suffered painful losses in their portfolios.

"The problem is if you wait until we are actually in it," said Chuck Roberson, a financial planner with Modera Wealth Management in Old Tappan, N.J., "it will be too late or the strategies won't work as well."

What follows are some of the most common strategies to inflation-proof your portfolio:

REVIEW YOUR MIX The inherent characteristics of a well-diversified portfolio — including a healthy dose of stocks — will help withstand inflation. If, for instance, your investments are split between domestic and foreign markets, which they should be, you already have a built-in hedge against the dollar and the American economy. Some financial professionals have added a diversified basket of foreign bonds to their fixed-income allocations. Others are hopeful about a recovery in Asia, so they are adding more money to Asian-based funds (minus Japan), while some planners have slightly increased their ratio of international to domestic stock funds.

SHORTEN UP Several financial planners recommend shorter-term fixed-income investments, or at the least making sure your bond investments aren't heavily tilted toward long maturities, because they are most affected by rising interest rates. (Newer bonds issued at the higher, prevailing rates make existing issues less valuable. So when interest rates rise, bond prices tend to fall. Bond funds and investors who hold securities with shorter maturities have the opportunity to reinvest at higher rates more quickly.)

"Fixed income is a disaster in inflationary times," said Steve Podnos, a financial planner in Merritt Island, Fla., who has been keeping his clients' fixed-income money in short-term, high-quality bonds funds like the Vanguard Short-Term Bond Index Fund. "You are giving up a couple of percentage points of income per year but inflation can do harm in terms of declining asset values."

For clients with at least $250,000 to invest in bonds, Gordon Bernhardt, a financial planner in McLean, Va., builds a bond ladder, spreading money evenly across a portfolio of bonds that mature at regular, but staggered, intervals. This enables you to replace maturing bonds with bonds that offer higher yields.

TIPS Treasury Inflation-Protected Securities, or TIPS, guard against inflation because the principal increases with inflation (but decreases with deflation), in tandem with the Consumer Price Index. Investors can either buy the securities directly, or purchase a TIPS mutual fund or exchange-traded fund. If you hold TIPS directly, you will receive the adjusted principal, or your original investment, whichever is greater, when the TIPS mature. Interest payments also rise or fall with the movement of prices.

While the allocation to TIPS will vary on a person's circumstances and goals, Scott Dauenhauer of Meridian Wealth Management has about 20 percent of his clients' fixed-income allocation in TIPS.

It is best to keep TIPS and TIPS funds in tax-deferred accounts like an I.R.A. because you'll be taxed on the amount your principal increases — even though you don't receive it until the TIPS matures. With mutual funds, those adjustments are distributed (and taxable) to investors each year as well.

COMMODITIES Commodity investments tend to perform well when there's inflation because rising prices usually mean a stronger economy at home (or elsewhere in the world). That, in turn, leads to increasing demand for raw materials to meet rising production and consumer needs. Don't be tempted to make individual bets on oil or gold, planners say. Instead, buy a diversified basket of commodities that tracks a major index like the Dow Jones-UBS Commodity Index from a low-cost fund or exchange-traded fund provider.

Investors have to determine what allocations are best for them, but planners said they would invest anywhere from 3 to 10 percent of a portfolio in commodities. Given commodities' volatility, investors need to rebalance their portfolio periodically to make sure their position doesn't balloon. These investments are also best kept in a tax-deferred account.

REAL ESTATE Real estate can also be a good way to hedge against inflation. Real estate investment trusts, which invest and own commercial and residential properties, are an easy way to gain access. Not surprisingly, REITs, which are required to distribute most of their income (generally from rent rolls) to shareholders, have been battered in the downturn. But they have shown signs of hitting bottom, and Mr. Gayle said it might be a good time to start building a position.

“But while it is an inflation hedge, it is a leveraged inflation hedge,” Mr. Gayle added. “Debt and access to debt influence the real estate market very significantly,” he added, “so that should be further down the list” of inflation protectors.

Investors with a higher net worth may consider foreclosures, as long as they have done their homework. “If inflation does come back, hard assets like real estate will start to move,” said Marc Schindler of Pivot Point Advisors. But you need to have a five- to 10-year time horizon and you don’t want to invest more than 25 percent of your net worth in real estate, he added. Still, he said, “if you are able to buy at a huge discount to market through foreclosure or other means, it will be a wise investment.”

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