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# INVESTING AND INFLATION: TIME TO PROTECT YOUR FUTURE?

U.S. VERSION

Most of us think of the return on our investments in nominal terms, or the stated return on an investment. In periods of low inflation, if you expect a corporate bond fund to yield 5%, thinking of this as a 5% return may not be particularly harmful.

When inflation increases, however, thinking in nominal terms can be very detrimental, especially to your long-term investment planning. Given recent events, it may be prudent to consider the next stage of the economy. The United States government has aggressively increased spending and its Federal Reserve, the U.S. central bank, has increased the money supply. If inflation results from these measures, thinking in nominal terms may reduce the probability of satisfying your needs and goals. Now may be a good time to think about your portfolio return above the rate of inflation, or in real terms, and to prepare for the risk of higher inflation.

## INVESTMENT INSIGHT

**Nominal Return:** The stated return on an investment. If you invest \$100 and get \$102 in a year, that is a 2% nominal return.

**Real Return:** The return on an investment adjusted for inflation (or deflation). A 2% nominal return in a 2% inflationary environment will leave you exactly where you started in terms of purchasing power, unless you are paying taxes on the interest, in which case you are worse off after a year. Your goal should include maintaining purchasing power, or your ability to pay for your future.

Inflation reduces investment returns and needs to be considered in constructing portfolios for different stages of investors' lives. Most investors want their investment portfolio to preserve and enhance their purchasing power over time. Preserving purchasing power means that investment returns must clear the inflation hurdle.

## LET'S LOOK AT DIFFERENT SECURITIES TO DETERMINE WHETHER THEY ARE LIKELY TO MEET THE INFLATION HURDLE.

### Cash/Short-term Bond Fund

Cash investments, such as savings accounts and money market funds, will often yield less than the inflation rate, reducing your portfolio's real return. While cash serves a useful purpose, it may be beneficial to consider a high-quality short-term bond fund for some of your liquidity needs.

The somewhat higher yield in a short-maturity bond fund can help to keep pace with inflation. Remember, however, that returns that seem too good to be true often entail unexpected risks, so proceed with caution. Review the latest prospectus to understand the fund manager's strategy and recent holdings. You may choose to skip a fund that contains securities with unfamiliar characteristics.

### Bonds

Medium- and longer-term bonds typically do poorly in periods of higher-than-expected inflation for two reasons. First, inflation erodes the purchasing power of a bond's fixed income stream. In addition, unexpected increases in inflation typically result in rising interest rates, which lower nominal bond prices.

Inflation-protected bonds are an important exception to the behavior of most bond investments in inflationary periods. These bonds protect investors against unanticipated inflation explicitly, because they promise to pay a real rate of return plus actual inflation. In the U.S., they are called TIPS (Treasury Inflation-

Protected Securities) and can be purchased individually to a target maturity date or within a fund that holds a diverse basket of maturities. Their special properties make them useful for investors who place paramount importance on maintaining purchasing power and desire the safety of a government-guaranteed bond.

## INVESTMENT INSIGHT

### **Treasury Inflation-Protected Securities**

**(TIPS):** Treasury Inflation-Protected Securities, or TIPS, protect against inflation. The principal of TIPS increases with inflation (and decreases with deflation) as measured by the Consumer Price Index (CPI). When TIPS mature, you are paid the adjusted principal or original principal, whichever is greater. Speak with your investment advisor about the tax treatment of the annual principal adjustment.

While TIPS offer protection against unexpected inflation, they share with conventional bonds the sensitivity to changes in interest rates and market sentiment. Note, however, that hold-to-maturity investors would still receive the payments, including adjustments for inflation, for which they bargained when they bought the security (regardless of changes in the quoted value of the bond). Work with your financial adviser to evaluate the role that TIPS can play within your portfolio.

### **Stocks**

Stocks are generally thought of as good inflation hedges over the long run as companies are able to charge higher prices to offset rising costs. Stock returns, however, may lag inflation, especially over shorter horizons. The recent decline in the stock market should underscore that equity investing is not for everyone or for every investment need. Match your goals and risk tolerance with an appropriate mix of investments.

### **Commodity Funds**

Sophisticated investors may address concerns about inflation by investing in commodity funds, which have value that fluctuates with prices of physical goods such as agricultural products, metals and oil. Actively managed funds within this category tend to concentrate on a narrow range of positions, and consequently can experience more volatile results than other fund types. Additionally, some funds invest in companies that produce commodities while others invest directly in the underlying commodity, which generally offers better diversification benefits. In general, commodity funds may serve the interests of longer-term sophisticated investors, often representing a small percentage of their portfolio.

### **Investing Amid Uncertainty**

Recent market developments underscore the importance of following the evergreen principle of "being prepared." Prudent investment planning suggests constructing a portfolio that will meet your needs and goals over a range of possible scenarios. While it is impossible to know with certainty how damaging inflation will be in your investment future, being prepared for the full range of possibilities, including a period of inflation, can make sense.

## WHY CHOOSE A CFA CHARTERHOLDER WEALTH MANAGER?

Many investors use specialists for the complex matters of life, and portfolio construction is a good example. Consider using a financial adviser who is a CFA charterholder to assist you in constructing a portfolio that will meet your needs and goals.

Today's financial markets demonstrate just how important it is to have reliable evidence of your financial adviser's integrity, experience, and commitment.

No credential is as widely regarded in the global financial industry for its rigorous focus on current investment knowledge, analytical skill, and fiduciary responsibility as the Chartered Financial Analyst (CFA) designation.

### A CFA CHARTERHOLDER IS:

- Credible:** Adherence to a code of ethics that puts the client's interest first and mastery of a comprehensive body of investment knowledge
- Committed:** Demonstrated professional experience and perseverance to undergo 18 hours of examination
- Current:** Exams updated with the latest and most relevant knowledge and access to world-class lifelong learning resources
- Connected:** Membership in a network of nearly 100,000 investment professionals in 131 countries

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