Leashing inflation before it bites

By Kim Clark @Money August 21, 2013: 4:04 PM ET

Protect your portfolio against inflation -- before consumer prices start to climb.

(Money Magazine)

The past few months have been hard on investors who bet on high inflation.

Despite doomsayers' warnings that the Federal Reserve's efforts to stimulate the economy would send consumer prices soaring, the market has turned against classic investments that rise along with inflation.

Consider the reaction to Fed chairman Ben Bernanke's comments on May 22, when he indicated that the central bank might soon scale back its large bond purchases. Fixed-income prices were hit, as the move was viewed as a sign the economy was strengthening and that interest rates would climb.

Yet Treasury Inflation-Protected Securities, or TIPS, fell even more than regular Treasuries. Meanwhile, the price of gold -- a favorite of the monetary winter-is-coming crowd -- plunged almost 13% over the following month.

What happened? Normally when rates rise in an improving economy, inflation fears also climb. This time, however, investors felt that if the Fed were to remove stimulus from the economy, that would reduce some inflationary pressures in the short run.

"People thought, 'Maybe this inflation protection is overpriced,'" explains Kathy Jones, fixed-income strategist at Charles Schwab.
Bond investors fear another 1994

Maybe it was, but the selloff has made it a better deal. And even if the risk of sharp increases in consumer prices is small, owning some inflation hedges is a good diversification policy in case the crowd is wrong.

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When the risk of high prices does become clear, insuring against it will be costly.

"Start building your inflation toolkit now," suggests Rob Arnott, chairman of Research Affiliates and manager of the Pimco All Asset Fund. "The best time to do it is when nobody is afraid."

Not all inflation hedges make sense now, though -- some, in fact, aren't even true hedges. Here are the best ways to protect yourself against rising prices that erode your real returns.

Add TIPS to your bond mix

TIPS are Treasury bonds with a twist: Their principal value, and thus their coupon payments, are adjusted along with the CPI. (You can also buy I Bonds -- inflation-protected savings bonds that work a bit differently -- but in limited amounts.)

With TIPS, you start off with a lower stated yield than regular Treasuries. In July, for instance, 10-year TIPS were yielding around 0.4%, vs. 2.5% for conventional notes. This means that if inflation were to exceed an annual average of 2.1% over the next decade, TIPS investors would earn more -- after their bonds' principal is adjusted for inflation -- than those who hold regular Treasuries.

That doesn't look like a very high bar. Gene Tannuzzo, co-manager of the Columbia Strategic Income Fund, says TIPS look attractive now, since there is a reasonable chance that inflation could average, say, 2.5% over the next decade. Should the spread in yields between TIPS and Treasuries dip below two points, he says, they'd be a "strong buy."

Shifting some assets out of your core high-quality bonds and into TIPS makes sense. But be careful if you're using funds. TIPS funds, like most bond portfolios, could drop in value if rates rise and bond prices fall in an improving economy. (Individual TIPS owners don't have to worry about this, as they can simply hold their securities until maturity).

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Of course, TIPS funds would lose less than other high-quality bonds in this scenario because at least TIPS offer you a safeguard against inflation.

You can further protect yourself by avoiding TIPS funds that invest in long-dated bonds, which are most at risk if rates rise. Go with an intermediate-term fund such as T. Rowe Price Inflation Protected Bond (PRIPX), with an average duration of 5.8 years.

Limit gold to your jewelry box until it's much cheaper

Whether gold is an effective hedge against inflation is up for debate. Duke business professor Campbell Harvey found that 2,000
years ago, Roman centurions received salaries in gold worth about what similarly ranked U.S. Army officers earn in greenbacks today. Trouble is, except maybe for Mel Brooks, people don’t live 2,000 years.

Though gold briefly outpaced other assets when consumer prices spiked in the 1970s, over the past century gold has often performed worse, after inflation, than stocks and bonds.

Lower-returning assets are supposed to expose you to less risk. But gold “is so dangerously volatile it cannot be relied upon to provide a hedge for inflation or disaster,” Harvey says.

How volatile? Gold plunged about 33% between October and June, wiping out more than two years' worth of gains. Other commodities, which have been mired in a bear market over the past two years, have produced similarly rocky results.

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Harvey adds that over the long sweep of history, the price of gold has averaged around $800 an ounce in today's dollars. "That is the red line. Below that, I would say it is cheap," he says. Gold had bounced back up to about $1,300 an ounce by mid-July -- making it as pricey as it is pretty.

If you do include gold in your strategy, "only commit a small amount of your portfolio" -- for instance, 3% to 5% -- says Laura Scharr-Bykowsky, a principal with Ascend Financial Planning.

**Think of stocks as long-run protection, but be picky**

Conventional wisdom says stocks are a natural hedge against inflation, as, over time, companies' earnings should grow along with the economy and prices. Here's the wrinkle: While stocks may adjust to higher prices over time, that doesn't mean they move in sync, especially in a crisis.

London Business School finance professors Elroy Dimson, Paul Marsh, and Mike Staunton found that in high-inflationary periods globally, stocks generally suffered annual real losses of about 12%.

Over longer periods, equities paid a risk premium that produced real gains of 5.4% of a year. The stocks that performed best against inflation, Marsh says, were those with high yields or a value tilt. Unfortunately, today's U.S. equities don't promise high yield or much value, argues Arnott.

So look abroad. The average holding of the Vanguard FTSE All-World ex-U.S. ETF (VEU) trades at a price/earnings ratio of 12.9 based on projected profits, vs. 14.3 for the S&P 500. VEU also yielded 4.7% over the past year, which is more than double the rate for domestic stocks. In the end, the best way to fight inflation may be to snap up as many bargains as you can spot today.

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