There’s No Perfect Way to Inflation-Proof Your Investments

There are pros and cons to almost every product or investment claiming to protect your nest egg from inflation.

By Anne Tergesen Follow
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With inflation at a four-decade high, many investors are trying to figure out how to protect their retirement nest eggs. But figuring out exactly how to inflation-proof your portfolio isn’t an easy task.

The need to stave off the threat of inflation stems from the fact that rising prices generally reduce the purchasing power of assets. For people on a fixed income in retirement, inflation means their retirement dollars might not go as far.

Among the options to counteract inflation are to add inflation-protected bonds to your holdings. Another approach is to defer claiming Social Security, to obtain a bigger inflation-adjusted retirement income.

There are other investment options, as well, but some are expensive. Others are volatile and had inconsistent performance during past inflationary periods.

“There’s no good answer,” said William Bernstein, an independent financial adviser based in Eastford, Conn.

There are pros and cons to almost every option. Here’s what to consider.

Social Security

One straightforward way to boost inflation-protected retirement income is to delay claiming Social Security benefits. Retirees would then need to spend more from their
investment portfolios to support themselves, but with the S&P 500 up 76% including dividends since March 31, 2020, it isn’t a bad time to sell some stocks, said Christine Benz, personal finance director at Morningstar, Inc.

Retirees can start these benefits any time between ages 62 and 70, but for every month of delay, the payment increases. Benefits are also adjusted annually to reflect increases in the Labor Department’s CPI-W, a measure of inflation affecting blue-collar workers.

For example, someone born after Jan. 1, 1960, who is entitled to $2,025 a month at age 62 would receive $3,587 before cost-of-living adjustments by holding off on claiming until age 70. With a 5% inflation adjustment, the benefit available at age 70 would be about $5,300, according to Bill Reichenstein, head of research at SocialSecuritySolutions.com, which sells Social Security claiming advice.

Cost-of-living increases start at age 62, whether you claim or delay, and continue for as long as you live. Based on the rise in third-quarter inflation, the increase for 2022 was 5.9%, the largest since 1982, according to Social Security Administration data.

Still, not everyone should delay Social Security. A person who postpones benefits until age 70 instead of 62 would have to live to 80½ years old to come out ahead, Dr. Reichenstein said.

I Bonds

When it comes to investments that aim to keep pace with inflation, “I bonds are the best of all,” Mr. Bernstein said.

Investors in these inflation-protected U.S. savings bonds are guaranteed to recover their principal plus inflation over 30 years.

They offer a fixed rate for up to 30 years, plus an inflation rate that adjusts semiannually and tracks the Labor Department’s CPI-U, a measure of urban inflation.

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How are you adjusting your retirement plans in the face of rising inflation? Join the conversation below.
You can buy them directly from the U.S. government at TreasuryDirect.gov.

Today, the yield on a regular U.S. 30-year Treasury bond is 2.24%. The I bonds’ initial annualized yield is 7.12%. With its fixed rate currently zero, I bonds won’t beat inflation. But since yields on conventional Treasury bonds are now negative when inflation is taken into account, I bonds have a clear advantage, said Mark Iwry, a nonresident senior fellow at the Brookings Institution who oversaw national retirement policy at the U.S. Treasury Department during the Clinton and Obama administrations.

A downside to I bonds is that each investor can purchase only up to $10,000 a year. An investor can buy up to an extra $5,000 if they elect to receive their federal income tax refund in I bonds, Mr. Iwry said.

Holders of I bonds are barred from cashing them in for the first 12 months and lose three months’ interest if they redeem within the first five years.

TIPS

When inflation exceeds expectations, prices of ordinary bonds typically get hammered. That is when Treasury inflation-protected securities, or TIPS, tend to do well.

Backed by the U.S. government, TIPS are bonds with principal and coupon payments that adjust to keep pace with the consumer-price index.

The bond market currently expects inflation over the next decade to average about 2.46%. That is the difference between the minus 0.51% inflation-adjusted yield on the 10-year TIPS and the 1.95% nominal yield on a regular 10-year Treasury note. If the CPI averages more than 2.46% over that time, TIPS will deliver a higher total return than Treasurys. If inflation is below 2.46%, the conventional Treasury will outperform.

With TIPS yields negative today, buyers would lose money on bonds they hold to maturity. That makes TIPS “a very costly method of inflation insurance,” said Campbell Harvey, a professor at Duke University’s Fuqua School of Business.

Last year, TIPS returned nearly 6% as inflation jumped, according to Vanguard Group.

This year, however, rising interest rates are creating problems for bond prices, which presents another risk factor for TIPS. Even if inflation is rising, a sharp decline in bond prices would also hurt TIPS.
You can buy TIPS through TreasuryDirect.gov, brokers or TIPS funds. Morningstar’s Ms. Benz suggests putting 10% to 20% of your fixed-income portfolio into TIPS.

**Stocks and Commodities**

**In a 2021 study,** Prof. Harvey and four co-authors looked at eight periods over the past century in which U.S. inflation was 5% or higher for at least six months and found that the inflation-adjusted return on stocks averaged minus 7% annualized.

Based on his research, Prof. Harvey suggests shifting money from the worst-performing sectors during inflation, which include consumer durable stocks such as auto makers, and into the energy and natural-resource stocks that tend to fare best.

Historical data in the study suggests that real-estate investment trusts, or REITs, may do well since landlords in the past have often been able to raise rents to keep pace with inflation.

Another potential asset is commodities, given that prices of metals, oil and agricultural products “tend to hold their value or even outperform in inflationary surges,” Prof. Harvey said.

Investors typically purchase them via funds that buy commodities’ futures.

Because commodities can have big performance swings, Amy Arnott, a portfolio strategist at Morningstar, recommends capping exposure at 3% or less of a portfolio. With prices up sharply this year, investors risk buying “at a high point in the cycle,” she added.

What about gold? It has kept up with inflation, but only over very long periods, such as the past century, Prof. Harvey said. Over the shorter horizons that investors face, it hasn’t been reliable due to its high volatility, he said.

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