

FINANCIAL SUCCESS IN AN INFLATIONARY ENVIRONMENT



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Investors, especially those in or nearing retirement, have recently faced many difficult financial challenges: historically low interest rates, government budget battles, and the prospect of higher taxes – just to name a few. With the central banks of the world aggressively printing money and economies like China and India driving global demand for basic commodities and materials – it may be a question of when, not if, another significant challenge will make a dramatic appearance: inflation. Inflation carries the risk that rising prices will reduce your purchasing power.

So, what is a prudent investor to do? The key is to modify your behaviors and position your portfolio to withstand the impact of inflation. The following is a short collection of planning considerations and investment strategies, which may be used to help mitigate inflationary risks and take advantage of potential opportunities in an inflationary environment.



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Spend Less/Save More!

Control discretionary spending. Your personal inflation risk depends on what you buy. Younger adults tend to consume more nonessential services and items such as technology. Nonstop marketing, stores overflowing with new gadgets and goods, a desire to keep up with friends, and the feeling that a little reward is well deserved all tug at our purse strings. Curb current expenses to keep your personal inflation rate down by curtailing or delaying spending on nonessential items and services.

Save more. It may seem like a simplistic suggestion, but in inflationary times, saving more is important to maintaining cash reserves and attaining nest egg goals. Inflation will push prices up. Your cash reserve and nest egg must grow accordingly to provide an effective cushion for “financial storms.” To keep pace with inflation, increase your savings rate by at least the rate of inflation.

Pay Down Debt?

Deciding between paying down debt or saving/investing extra cash? It isn't easy. Each option has advantages. Start by choosing one option. Then weigh what you'll gain financially against what you'll give up. In economic terms, this is known as evaluating the lost opportunity cost.

Here's an example: By making extra mortgage payments, you save on interest. You'll clearly be gaining a lot of financial ground. But before you prepay your mortgage, consider what you might be giving up: the potential opportunity to profit even more by investing.

If you compare historically low CD, Treasury and other fixed income returns against current mortgage and borrowing rates of four percent, five percent and higher, you may think the decision would be easy. However, inflation typically pushes up the cost to borrow. Using extra funds

to increase savings may be much more beneficial, especially if that five percent mortgage has a fixed interest rate, and the younger you are, the less likely you are to be investing that extra cash solely in CDs and Treasuries.

Those within three to four years of paying off their mortgage may want to consider accelerating their payoff as a valid alternative to low CD and Treasury returns. Think of the interest savings as a secure return comparable to Treasuries.

Reconsider Bond Holdings

Many investors have increased their bond holdings the past couple of years as a reaction to the sharp decline in stocks in 2008 and as bonds have traditionally played a key role for those in or nearing retirement. Bonds remain an integral component of a well-diversified portfolio. Investors near or in retirement, however, should consider the eroding impact inflation has on the purchasing power of fixed income cash flows and, in the event they need to liquidate, on the value of their bond. Investments, including bonds, are subject to market risk, including possible loss of principal.

A floating rate or variable payment bond protects against these inflation risks. Investors who plan to hold individual securities to maturity and are primarily concerned with the income stream they will generate should consider Treasury Inflation-Protected Securities, or TIPS.

TIPS are a type of U.S. Treasury bond. The principal of the bond is adjusted

periodically for inflation. Therefore, both the par value of the bond and the income stream keep pace with inflation. It is important to note that increases in TIPS principal value as a result of inflation adjustments are taxed as capital gains in the year they occur, even though these increases are not realized until the TIPS are sold or mature. Conversely, decreases in the principal amount due to deflation can be used to offset taxable interest income.

Don't Forget Dividend Stocks

Dividend paying stocks have long been the favorite of investors seeking a good hedge against inflation risk. In an inflationary environment, dividend distributions offset a decline in the value of the stock. Historically, strong, long-term price stability of these stocks deserves as much attention as does the reliability of dividend distributions.



Investors who favor dividend paying stocks will be pleased to learn that the number of companies issuing dividends has increased in recent years. And, companies whose businesses thrive in an inflationary environment may actually pass that benefit along to investors in the form of an increased dividend. Although, these are definitely some attractive aspects of dividend paying stocks in inflationary times, dividends are not guaranteed and will fluctuate.

Consider “Stuff” Stocks

Investors concerned about inflation should consider allocating a portion of their portfolio to investments that tend to outperform in an inflationary environment such as “real assets.” The term “real assets” generally refers to tangible commodities, “stuff” you can touch. These commodities include natural resources like oil, gas, coal, industrial metals, precious metals, as well as tangible assets like agriculture and forest products, livestock, corn, wheat, cattle, etc. Commodities are generally considered speculative because of the significant potential for investment loss. Because commodities are volatile investments, they should only form a small part of a diversified portfolio. There may be sharp price fluctuations even during periods when prices overall are rising.

Unfortunately, direct investment in commodities is simply not easy or practical for many investors. For suitable investors, a more feasible approach is to invest in equities of the companies that produce commodities (sometimes referred to as “stuff stocks”) or more broadly diversified managed products that hold such stocks.

Look at Emerging and Frontier Markets

Inflation can benefit countries rich in commodities and natural resources such as those in the emerging and frontier markets. We are a good example. Around the end of World War II, our abundant access to natural resources and efficient production

of commodities fueled widespread growth in consumption and elevated the United States to economic superpower status.

Today, many countries around the world are undergoing a similar evolution. To be sure, the world economy and markets still face significant challenges. Still demographic trends suggest there is significant opportunity in certain global markets for patient, long-term investors. Even so, that does not necessarily mean



investors should immediately begin loading up on emerging and frontier market stocks. International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

International revenues are a significant component of total returns for a number of the largest United States based companies. In fact, many of these firms generate more than half their sales revenue outside our country. Investing in high-quality domestic firms with strong global brands allows investors the potential inflation hedge of emerging and frontier market investment without the potential over exposure of

direct investment in emerging and frontier market stocks.

Don't Be Your Own Worst Enemy

Behavioral finance experts advise that improved investment performance starts with a simple acknowledgement that may not seem helpful at first. It's this: Humans are not designed to be successful investors.

Now with that out of the way, there are things we can do to attempt to achieve better results, including:

- Define what you really want from your investments. Translate that into specific goals and write them down.
- Create a long-term investment strategy that reflects individual objectives and makes risk management an integral part of that strategy.
- Identify your emotional biases and recognize that while we may not be able to change them, we can find ways to work around them.
- Consider emotional biases carefully before deviating from a long-term investment strategy.
- Recognize that stress is an unavoidable part of investing and develop ways to cope with it, perhaps by choosing more conservative investments.
- Be willing to ask for, and accept, help from others.

As with any challenge connected to the complex global economy and financial markets, there is no single, simple solution. It is important to remember that no matter what you decide now, you should always reassess later.

The headwinds of pending inflation demand a balanced adherence to the time-tested principles of risk tolerance, selectivity of investment themes, and diversification. Although diversification does not ensure a profit or guarantee protection against a loss, sound planning and execution can lead you to longer-term investment success. [CS](#)