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BUSINESS

Don't let inflation deflate your investments

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Inflation is the monetary thief that robs consumers of their current purchasing power and diminishes the future value of retirement nest eggs.

"You need to invest to keep up with inflation," said Roch Tranel, president of Tranel Financial Group in Libertyville, Ill. "If it weren't for inflation, people wouldn't mess around with all the volatility in the stock market."

The impact inflation has on a person's investment portfolio depends on the type of securities they own.

Some investors are content to ride out today's turbulent stock market with a conservative mix of bonds, CDs and money market accounts, but often the rate of return on those investments may not be high enough to beat inflation, which is currently pegged at 5 percent.

If a bond or CD pays 4 percent annual interest and inflation is running at 5 percent, the investor actually loses 1 percent on the investment each year to inflation -- and still must pay taxes on the 4 percent gain, which results in a greater loss.

"Inflation is a compelling reason why clients would want to have a stock exposure in their portfolio, depending on their age," said P.J. DiNuzzo, president of DiNuzzo Investment Advisors Inc. in Beaver. "They would want to have at least 30 percent in stocks to help minimize the effects of inflation."

The Bureau of Economic Analysis reported last week that inflation was steadily intensifying. Higher energy and food prices pushed inflation up 0.8 percent in June, which was the biggest monthly increase in 27 years.

Picking winners

When stock prices rise due to inflated earnings and revenues, it becomes difficult for investors to get a clear picture of a stock's true value.

The problem is that some companies are faced with higher production costs, but have not found a way to pass those costs on to consumers. Companies that produce items such as clothing, automobiles and furniture recently have had to reduce their prices to keep or attract consumers.

"What investors should be worried about is what are the future expectations for future earnings," said Brian Levitt, an economist and vice president of Oppenheimer Funds in New York. "If companies are faced with higher input costs and can't pass it on, profits shrink."

Mr. Levitt said he believed that biotech and medical companies have the greatest chance for success when inflation is on the rise.

"For investors in the equity markets, they need to think about which companies can grow their businesses in such an environment," he said. "Who has pricing power, foreign exposure and the ability to grow a business in a declining U.S. economy?"

Watching bonds

Many investors prefer the safety of bonds. But inflation can devastate a bond portfolio.

"There's nothing worse for a bond portfolio than inflation," said David Twibell, president of Colorado Capital Bank in Denver. "It eats away at the purchasing power of the portfolio, and as the Fed raises rates it also decreases the value of the bonds -- a double whammy."

One strategy he uses for clients is to put a portion of their assets in floating rate bonds, which are corporate bonds with interest rates that increase based on the London Interbank Offered Rate, so they don't lose principal value.

"Also, we try to keep maturities short on bonds so as they mature, we buy bonds at higher rates," Mr. Twibell said.

Bond investors also might consider Treasury Inflation-Protected Securities, known as TIPS, which provide protection against inflation. The principal increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Power of inflation

The simple definition of inflation is when too much money is chasing too few goods.

When there is an increase in the supply of money and easy availability of credit, there is a general rise in the demand for goods, which results in inflation.

The ravaging effect inflation can have on spending power is well illustrated by the hyperinflation that rattled Germany and Hungary after World War I when a typical family's life savings could not buy a loaf of bread. A more recent example of hyperinflation is being played out in Zimbabwe, a country that recently introduced the world's first $100 billion bill, which is equal to about 80 cents in U.S. dollars.

"I expect inflation to continue because the Fed is under pressure to keep interest rates low to combat the credit crisis," said Addison Wiggin, author of "The Demise of the Dollar ... And Why It's Great for Your Investments."

"Society is addicted to easy credit at the personal consumption and banking level," Mr. Wiggin said. "The natural tendency is to inflate the currency, and we expect that to continue for some time."

Investing options

Mr. Wiggin recommends that investors focus on buying assets such as natural resources, commodities and gold, because when inflation is rampant prices for those asset classes benefit.

James Turk, founder of GoldMoney.com, based in the British Channel Islands, and author of "The Collapse of the Dollar," said he disagreed with the point of view that stocks are the best inflation hedge. "They help protect you against inflation, but the best inflation hedge is gold," he said.

Although gold does not pay a dividend or generate a stream of income, investors who buy the metal are betting that its price will appreciate faster than the rate of inflation.

"We're in one of those moments in time when you want to be out of the stock market and in cash," Mr. Turk said. "But not dollars. Gold should be your liquidity. Gold is money. Historically it has maintained its value over long periods of time."

John Schloegel, vice president of investment strategies at Capital Cities Asset Management in Austin, Texas, is predicting, however, that inflation will decrease in the months and years ahead.

Mr. Schloegel believes that the greater concern for investors is deflation.

"Home prices are declining at a substantial rate, and that's a big asset on everyone's balance sheet," he said. "Wages are significantly embedded in corporate costs. Wage growth is not inflationary, but minimal at best.

"We are in a recession and that will lead to a decline in other high cost items such as gas and groceries," he said. "Those prices will come down in the next six months without the Fed taking any further action on interest rates."

Bob Hapanowicz, president of Hapanowicz & Associates, Downtown, believes, however, that interest rates will go up in response to rising inflation.

"We think the way to hedge portfolios from the effects of inflation is to invest in carefully selected stocks," he said. "Stocks have historically since 1925 averaged about 10 percent a year, and that beats inflation over that time period by 3.5 percent.

"In the short term, stocks may be volatile. But in the long term, they should provide the inflation hedge."

Mr. Hapanowicz also suggests that investors add commodity ETFs, such as the Rogers Global Commodity Index (RJI), to their portfolios. He believes that Treasury Inflation Protected bonds would at least keep up with inflation and that REITs could be good investments, too, now that many of them have bottomed out.

Ultimately, investors must balance their financial strategy to outpace inflation with their own tolerance for risk, said Julie Murphy Casserly, president of JMC Wealth Management in Chicago and author of "The Emotion Behind Money: Building Wealth from the Inside Out."

She believes that the stock market is poised for a turnaround and suggests that investors have at least 20 percent of their portfolios in stocks, but that they should diversify the sectors in which they are invested.

"Stocks," she said, "are the only thing shown to outpace inflation in the last 100 years. Bonds, savings accounts and CDs are terrible now.

"You are starting to see some of the really big investors come back into the market," Ms. Casserly said. "I think we are doing a great job as a country (with inflation) compared to the 1970s by keeping interest rates low. But we are in uncharted waters and only time will tell."

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