Is Inflation Around the Corner?

How to tweak your portfolio so you can't get hurt BY Russell Wild

ANYONE WHO REMEMBERS the double-digit inflation of the 1970s has to be a bit leery about the possibility of its return. Some pundits, pointing to recent increases in commodity prices (bought any gas for your car lately?), warn that a big surge could be coming as an overreaction to the economic stimulus. Or worse, others say that the economy could remain in the doldrums while costs soar—a condition known as stagflation. And man-on-the-street surveys from last year revealed that consumers were expecting a price spike, big time, any day. A year later, the popular consensus is exactly the same—prices are rocketing, and, yup, you'll soon be paying $100 for a hamburger.

But how likely is that? Not very, say the experts. Certainly there are forces at play that could lead to higher inflation, concede Alan Levenson, Ph.D., M.B.A., chief economist at T. Rowe Price, and Jeremy Siegel, Ph.D., Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania. These forces include the recovering global economy, increasing demand for commodities (especially in countries with rapidly growing populations), and low interest rates here at home.

But, with unemployment still high and the economy growing slowly, the pressures that historically have created high inflation, such as we saw in the late 1970s and early 1980s, simply aren't present, says Levenson.

Those who fear hyperinflation like to point to the government debt, assuming that debt must lead to inflation. But that isn't necessarily the case, says Siegel. After WWII, for example, government debt was 120 percent of the Gross Domestic Product, considerably higher than it is today, and yet the decades following WWII, the 1950s and 1960s, were actually very low-inflation periods.

Bottom line: Both Levenson and Siegel make modest predictions for inflation of between 2 and 4 percent in coming years. What's to worry about, then?

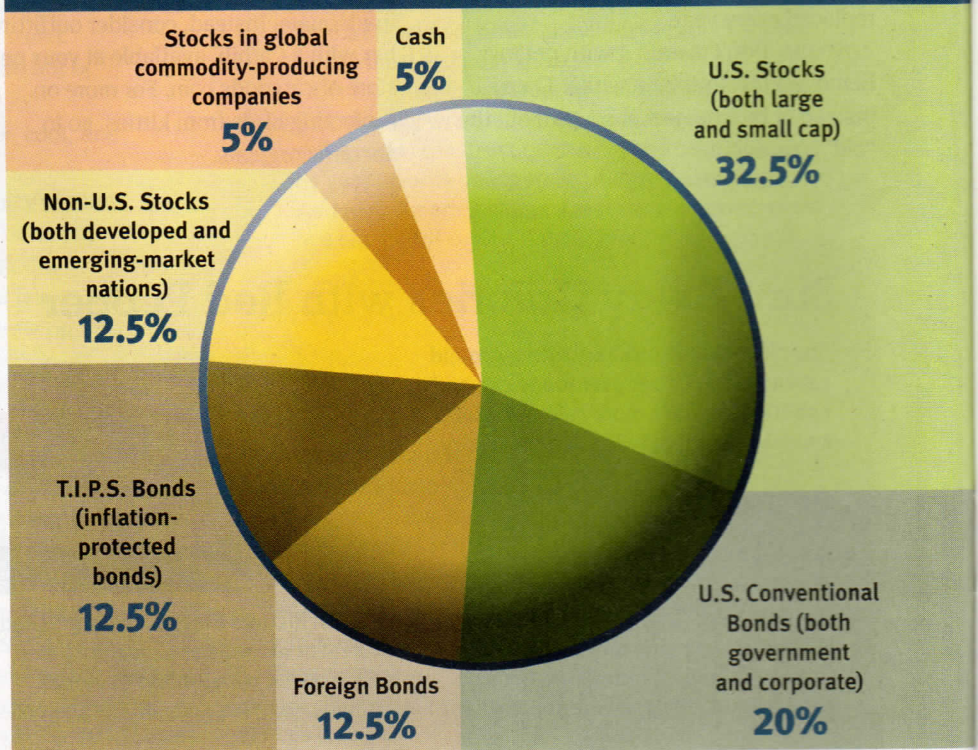
Well, maybe worry is the wrong word. Preparation is a better one. Reason: Predictions are inaccurate by definition. Inflation may, in fact, run higher. And even if it runs near its historical norm—3.0 percent over the past 85 years—that can seriously eat away at your spending power over time. Preparation starts with a well-balanced portfolio (see below), says Cary Carbonaro, M.B.A., a Huntington, New York-based financial planner with Stonegate Wealth Management. Two general inflation-fighting principles apply:

1. Stay in Stocks

Although many of us have decreased stock holdings for fear of volatility, it's important to remember that stocks over time do an excellent job of keeping up with inflation. According to data from T. Rowe Price, there has never been any 20-year period in recent history where stock returns did not outrun the

Inflation-Proofing Your Portfolio

Your portfolio needs to be tailored to suit your need for growth and your tolerance for risk. That being said, a middle-of-the-road portfolio such as the one illustrated below should hold up well in times of inflation.



rate of inflation. Within the universe of stocks, however, some tend to fare better than others in times of higher inflation. You might, says Carbonaro, consider devoting a portion of your stock portfolio—perhaps 10 percent—to a stock fund that invests in companies that produce or extract commodities, such as mining or oil companies. Investing directly in commodities like gold and silver can be warranted as well, but the volatility makes it dangerous, and you need to be cautious, especially when the prices are sky high.

Make sure that your stock portfolio also includes a good dose of non-U.S. stocks. If inflation rages, these foreign funds, which are based on currencies other than the dollar, might do very well. An appropriate range might be about one-quarter of your total stock allocation.

2. Hedge with Bonds

Conventional bonds that pay a steady stream of income get clobbered by inflation. Bonds are an important part of any portfolio, "but you may want to invest perhaps 20 to 30 percent of your bond portfolio in Treasury Inflation-Protected Securities (TIPS) and foreign bonds," says Carbonaro. TIPS pay very modest interest, but twice a year your principal is adjusted to match the Consumer Price Index (CPI). If the CPI goes up, say, 5 percent, Uncle Sam will give your principal a 5-percent boost. You can buy TIPS directly from the U.S. Treasury at treasurydirect.gov or through a low-cost provider such as Vanguard, T. Rowe Price, or iShares. For foreign bonds, Carbonaro likes especially the Dreyfus International Bond fund (DIBRX).

We hope that a hamburger won't cost $100 anytime soon—but, eventually, it may. Properly prepared, you should be able to afford it—along with the $50 fries and $30 Coke. ♜

Russell Wild, M.B.A., is a NAPFA-registered financial advisor who has written and co-authored nearly two dozen books, including *One Year to an Organized Financial Life*.

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