Guarding Your Portfolio Against Inflation

Since the New Year, stocks have already risen 5.5%. Short term interest rates are near zero and long term rates are rising. A whiff of inflation is in the air.

So where do you put your money so it grows and protects you against inflation?

A wise choice is to diversify across stocks and bonds.

While a lot of investors understand stocks (even though we are all still confounded by market moves from time to time), their understanding of bonds is a little fuzzy, or perhaps a bit too simplistic.

Many think bonds are safe, relatively risk free, and preserve capital nicely - not all true. So let me share a few thoughts on investing in bonds.

Bond Math (dare I use the M word!)

Say that in January 2010, you paid $100,000 for a bond that matures in 20 years and yields 4%. Your $100,000 investment will earn $4,000 in annual interest for the next 20 years.

Now, assume that in January 2011, interest rates increase to 5% on fresh bonds with identical credit ratings as your bond.

Q: How has this rate increase from 4% to 5% impacted the market value of your Jan 2010 bond?

A: Your bond has dropped in value and is now only worth $87,830, down from the $100,000 you paid for it a year ago. Not cool.

Assume again that in January 2012, rates go up another notch to 6%.

Same Q: How is your bond's market value impacted?

A: Your bond has dropped even more, and is now only worth $77,510. @%#$*^&… !!

As interest rates rise, bond values drop.

Interest Rate Risk

Now, you may say you're indifferent to all this because you don't plan to sell, and are happy collecting $4,000 in annual interest and $100,000 on maturity.

Well, in a sense, you're absolutely right.

But do know that there is a downside to your investment - your money is tied-up at a rate that isn't keeping up with rising inflation, and so is losing buying power.

This interest rate risk is the problem with owning long term bonds.

Long Term, Short Term, or Both

Moreover, the decision to own long-term versus short-term bonds really depends on your specific situation.

Allow me to explain.

The table below shows the maturities of Treasury bonds and their respective yields.

Maturity	1-month	3-month	6-month	1-Year	2-Year	3-Year	5-Year	7-Year	10-Year	30-Year
Yield %	0.076	0.117	0.162	0.286	0.814	1.375	2.342	3.035	3.647	4.716

1-month Treasury bonds yield merely 0.076%, 1-year Treasurys yield 0.286%, 10-year Treasurys yield 3.647% and so on. Typically, as maturity increases, yields rise.

Now, some of my clients in their 80s keep telling me that they only want to buy short-term bonds to make sure they beat inflation. I ask them to reconsider their logic.

If they invest $100,000 in a 1-year Treasury bond at 0.286%, they only get $286 in annual interest income. But if they invest $100,000 in a 30-year Treasury at 4.716%, they receive $4,716 in annual interest – quite a bit more.

So my advice to them is to earn and enjoy the higher interest income provided by longer-term bonds. And anyway, let your children or inheritors worry about inflation and re-invest your money as they see fit after you're gone, while you golf with your long departed buddies in that big blue sky above with a skip in your step and no green fees to pay!

Bond Portfolio Tips

It's different for younger investors, who must worry about inflation and keeping the purchasing power of their money intact over long periods of time. Interest rates can rise, stay unchanged, or drop depending on economic fundamentals. So, to handle this challenging task, here are a few tips on setting up your fixed income portfolio to account for inflation:

1) Buy inflation sensitive bonds like Treasury Inflation-Protected Securities (TIPS)
2) Stagger the maturities of the bonds you buy, so they mature on a regular basis – this gives you the flexibility of re-investing your maturing principal in a higher yielding bond
3) Monitor the "call" features of your bonds to maximum effect (this may let you redeem your bond earlier than its maturity date, and reinvest your principal at higher rates)

If you need to make fixed income investments, make sure you get the highest return available while retaining the flexibility of investing your money at higher rates in the future.

And understand the interest rate sensitivity of your fixed income portfolio so you can always stay a step ahead of the inflation game.