

Fear of INFLATION! (published October 2010)

— *By Steve Tepper*

Since the last spike in the 1980's we have enjoyed relatively low levels of inflation for several decades. Annualized rates have only topped 5% a couple of times, most recently in 2008, and mostly driven by energy costs. (Remember \$147-per-barrel oil?)

But since the last three federal budgets have blown the roof off the annual deficit, fear of a new round of inflation has concerned many investors. There is still concern that government spending and Fed policy will increase the money supply too much, diminish the value of the dollar, and lead to high inflation.

So will that happen? I think you know what our answer is: We don't know. We don't build an investment strategy around short-term market predictions. But it is important to know how our strategy could be impacted if we hit a period of high inflation.

First let's look at different investment options, and then assess, based on prior performance and academic research, how they would be expected to perform in an inflationary period. The options we will consider are 1) Cash; 2) Gold and commodities; 3) Short term bonds; 4) Inflation-protected bonds; and 5) Equities.

1) Cash: Two words: Bad idea. One of the worst characteristics of cash investment is total exposure to loss of purchasing power. Simply put, inflation lowers the value of cash. Prices go up, but you have the same amount of cash, so you can buy less. One step up from cash would be money market funds or bank CD's. While you can expect some return on these investments, historically they have not been good hedges against inflation.

2) Gold and commodities: This is where we're hearing a lot of talk. Not surprising, a lot of the talk is from the gold industry. Not to say they have a vested interest...

The claim (pardon the pun) is that gold is an excellent investment during periods of inflation, as investors flee to the perceived safety of commodities. Currencies can collapse, as can companies and even nations, but gold is a rare commodity. The supply is fixed, the demand is great. Is this sounding a little like the same argument we heard for real estate investment?

The Northstar strategy does not include investment directly in commodities, or in funds that directly own or trade commodities. Our investment goal is to capture the significant positive expected returns offered by capital markets over time, and we are confident of a future positive return because capital markets are designed to grow. Money that flows to corporations allows them to create and sell new products and services which propel the economy forward. This increases the worldwide value of all capital markets, and we invest to capture that.

As a side note, investment in a diversified portfolio does have a significant exposure to commodities because we own the companies that excavate, transport, store and sell those commodities. While you

didn't own oil futures in 2008, you still shared in Exxon Mobil's record profits (which helped pay that \$70 tab every time you filled your tank!)

Commodities are not revenue-generating assets like corporations. They do not change or evolve. They just exist. Their value is linked to investor perception, particularly the perception of future supply and demand.

The academic world tells us that commodity values are extraordinarily volatile and do not always mirror inflation. That was certainly the case in the 1980's, a period of high inflation. The total inflation rate for the decade was just over 62%, but the price of an ounce of gold actually fell 34% during that period from \$590 to \$391.

We also know from the academic community that higher commodities exposure in your portfolio will lower your expected return over time. So if trying to guess the right time to hold commodities isn't a good strategy, and just holding them long-term isn't good either, we say it's best to pass.

3) Short-Term Bonds: Because interest rates tend to rise when inflation increases, some investors may decide that bonds are the place to be when inflation spikes. While long-term bond interest rates may look more attractive, short-term bonds tend to be a better hedge against inflation as they are less sensitive to changes in interest rates. Also, if rates continue to rise, short-term bonds will mature more quickly and allow reinvestment at the higher rates.

The downside is that as interest rates fall, short-term bonds expose investors to reinvestment risk. That is, the proceeds from your maturing bonds will roll over into lower rate bonds.

4) Inflation-Protected Bonds: Treasury Inflation Protected Securities, or "TIPS" are bonds with an interest rate adjustment feature designed to increase during inflationary periods. TIPS are less volatile than non-adjusting bonds and as with other bond classes, have a low correlation to equity investments, making them a good investment to diversify your portfolio.

But as with any investment with an added feature, there is a price. In this case, the interest rate of a TIP bond would be lower than an equivalent non-TIP bond, and if inflation does not produce an adjustment to the interest rate, the bond's performance will lag a non-TIP bond.

5) Equities: With all the talk over the last couple of years about gold as a hedge against inflation, I've heard little about the value of equities to accomplish that goal. And yet, that is the simple truth. Over long periods of time, equities have provided a substantial positive real return (the return net of inflation). When you get a return higher than the inflation rate you protect your purchasing power. We mentioned in our discussion of commodities that gold actually fell in value during the high inflation period of the 1980's. During that same period, the Dow Jones Industrial Average increased 173%, from 964 to 2634! If instead of buying gold, the investor had bought large cap U.S. stocks, he would have been much better off.

Summary: Of the five asset classes we've discussed, the two worst inflation hedges are cash and commodities. Short-term bonds, TIPS and equities all do the job better.

Northstar's strategy is consistent with providing investors with a high level of inflation protection: We keep cash to a minimum – it's only purposes are to cover transaction costs and fees and to meet your short-term liquidity needs. We do not invest in commodities as a distinct asset class. We have a bond component in your portfolio, and it is tilted toward shorter maturities, and if appropriate, TIPS. And of course, we keep our clients invested in equities.