SLAYING THE INFLATION DRAGON

Inflation may soon breathe fire on your retirement savings, and traditional portfolios of stocks and bonds are at risk. Here's how to choose investments than can prevent your nest egg from getting cooked

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When you read about all the money central banks are creating to keep the world economy afloat, you may wonder how it will affect your retirement portfolio. You don't need to be an economist to understand that increasing the money supply eventually leads to inflation, which in turn erodes the value of your money. Sure, the inflation beast has been tame in recent years—it's averaged 2% for the last decade—but as bond guru Bill Gross recently commented: "While they are not likely to breathe fire in 2013, the inflationary dragons lurk in the 'out' years towards which long-term bond yields are measured."

Retired people are even more vulnerable to inflation than younger folks still in the workforce. If you're earning a salary, chances are it will increase during inflationary times and help cushion the blow from the rising cost of living. But if you're no longer earning income from employment, your portfolio has to do all the heavy lifting. Traditional building blocks such as GICs, bonds, and even stocks may not be up to the task. It may be time to think about protecting your retirement savings from the ravages of those inflationary dragons.

INFLATION'S BITE. When investors worry about inflation, one of their practical concerns is rising interest rates. As the world economy struggles, central banks have drastically cut short-term rates to encourage businesses and consumers to spend more. They've also helped drive down long-term interest rates by buying up government bonds and mortgages through a strategy known as "quantitative easing," or QE. Like anything else you buy, bonds are subject to supply and demand: when central banks buy bonds in massive amounts, the prices of those bonds move higher. Since bond prices and yields are like opposite ends of a seesaw, bidding up the price drives interest rates down.

Problem is, central banks finance their bond-buying sprees by creating money essentially from thin air, and economists fear this will eventually cause a spike in inflation. The classic definition of inflation is price increases caused by too much money chasing not enough goods and services. That's not an immediate worry, because the developed world still has loads of unused capacity and high unemployment. But eventually that slack will get used up and prices will have nowhere to go but up. "There will be a time when inflation rears its ugly head," says David Rosenberg, chief economist and strategist at Gluskin Sheff and Associates.

At some point interest rates will rise too, and that might occur even before we see any general surge in prices. In fact, central banks like to bump up short-term rates to stall inflation before it gathers momentum. The Bank of Canada is expected to start modestly raising short-term rates in early 2014 to "mop up excesses in the system," says Derek Burleton, deputy chief economist at TD Financial Group. (The U.S. Federal Reserve will probably hold off increases to its benchmark short-term rates for longer.) Meanwhile, longer-term rates will probably rise whenever major central banks ease off on QE purchases.

Will inflation stay contained? Will interest rates rise a little or a lot? When will it happen? Nobody knows, but worries abound. "When all the money printing by central banks ends, it won't be pretty," predicted Bill Gross recently in *Barron's*. The question for retirees is whether to make portfolios more inflation-resistant now, or wait until inflation is a more imminent threat.

Gross, who manages the world's largest bond fund, believes in acting now. Rosenberg says the bigger issue today is trying to find adequate investment income without undue risk. But he too believes it's prudent to have at least some of your portfolio in inflation-resistant investments.

Unfortunately, the traditional balanced portfolio of stocks and bonds doesn't do especially well when interest rates and inflation are on the rise. Fixed income suffers the worst: when interest rates soar, bond values plunge and inflation eats away at the purchasing power of the interest and principal. Stocks generally fare better, but seldom thrive in this situation. Companies can often increase prices to offset inflation if the economy is doing well, but their costs rise too, so profits don't necessarily flourish. So, are there investments that can make your portfolio more inflation-resistant? Fortunately, there are.

FIXED-INCOME LADDERS. With fixed income you can never totally protect yourself from rising interest rates and inflation, but you can reduce the impact. The most obvious way is to shorten the term of your interest-bearing investments. The sooner a bond or GIC matures, the sooner the money can be reinvested at current rates. And if short-, medium- and long-term interest rates all move higher, bonds with the shortest maturities will see the smallest price declines. But you give up something to get that protection: long-term bonds currently yield almost two percentage points more than short-term bonds.

You can strike a happy medium by constructing a bond or GIC "ladder," says Hank Cunningham, fixed income strategist at Odlum Brown Ltd. and author of *In Your Best Interest*. To build a five-year ladder, purchase equal amounts of GICs or bonds that mature in one to five years. Every year, one-fifth of the ladder matures, and you can use that money to purchase a new five-year GIC or bond at current rates. To be sure, rising inflation would eat away at the purchasing power of your interest and principal, but the continual repricing of 20% of your portfolio every year allows you to gradually capture the benefit of higher rates. Cunningham says a 10-year ladder can provide some additional yield, but it would also be more susceptible to inflation: only 10% would be repriced each year at current rates.

RETIREES ARE VULNERABLE TO INFLATION BECAUSE THEY CAN'T RELY ON RISING SALARIES

To get higher yields—albeit with more risk—you can build your ladder with individual corporate bonds instead of government bonds or GICs. Or you can use ETFs for added diversification. Cunningham recommends using RBC's family of target-maturity corporate bond ETFs (ticker symbols RQA to RQI): each one holds 25 or more bonds that mature in a given year.

REAL-RETURN BONDS. Unlike conventional bonds, real-return bonds provide excellent inflation protection. RRBs are long-term bonds with a value that's adjusted twice a year according to the current inflation rate. If inflation turns out to be what the market expects, RRBs will deliver the same returns as traditional bonds of the same maturity. If inflation is unexpectedly high, however, they will outperform. (For more see "Make Your Bonds Real" in our December/January 2012 issue or at moneysense.ca)

But there are drawbacks, Cunningham says. For one thing, current yields on RRBs are very low, so while you are assured of covering inflation you don't get much more. For example, a Government of Canada RRB maturing in 2036 now has a "real yield" of only 0.51%. That means your interest will be adjusted to ensure you earn the current rate of inflation (as measured by the Consumer Price Index, or CPI) plus 0.51%. The principal you receive when the bond matures in 2036 would also be adjusted for inflation.

Real-return bonds are highly sensitive to interest rate hikes. If long-term rates were to creep higher without any change in the CPI, the price of these bonds could plummet without any offsetting benefit from the inflation adjustment. Cunningham calculates that an uptick in long-term interest rates of half a percentage point (50 basis points) with no change to inflation—or inflation expectations—would cause the price of the 2036 Government of Canada RRB described above to drop in value by about 10%. So you're only assured of getting the full inflation-fighting benefits if you hold the bond to maturity.

GOLD. Just about every investor seems to have a strong opinion about gold. Some, like Bill Gross, are fervent believers. Others are impassioned skeptics. Gold advocates consider the metal a good hedge against inflation and against poor financial management by governments that control paper currencies like the U.S. dollar or the euro. Governments are always tempted to create more currency than can be justified by economic fundamentals. By contrast, the supply of gold is limited by the high cost of mining, so gold bugs consider it a more reliable store of value.

Others are wary because gold prices depend heavily on the whims of investors, since little is used in the production of goods integral to the economy. It isn't subject to "real demand and real supply," says gold skeptic John Stephenson, portfolio manager at First Asset Investment Management. Many arcane factors affect the price of gold, from jewellery demand in India to whether central banks are buying or selling it. As a result, gold has not always been highly correlated with inflation.

If you do want to add some gold to your retirement portfolio, an ETF is probably the best way to do so. The iShares Gold Trust, for example, trades on the Toronto Stock Exchange with the ticker symbol IGT. (You can also buy it in U.S. dollars on the New York Stock Exchange, where it trades under the ticker IAU.) Other investors prefer to invest in gold-mining companies, although share prices have generally done poorly in the last several years because mining costs have risen faster than gold prices.

HOW TO MAKE YOUR PORTFOLIO MORE INFLATION-RESISTANT

STRATEGY	WHY IT HELPS	DISADVANTAGES
Shorten term of fixed income	Shorter terms are less sensitive to rising interest rates and inflation	Short-term bonds and GICs generally pay lower yields
Bond and GIC ladders	Insulates you from immediate price declines caused by rising rates. You also benefit from higher rates for investments added to the long end of the ladder	Rising inflation will still erode the real value of interest and principal until the ladder is gradually repriced at higher interest rates
Real-return bonds	Interest payments and principal are adjusted for inflation as measured by the Consumer Price Index	Real yields are extremely low now so you don't get much more than the rate of inflation. Prices will suffer if interest rates rise before inflation
Gold	Gold supply is limited by high mining costs, whereas governments are prone to creating too much currency. Gold advocates consider it the better store of value	Because little gold is used in the production of goods and services, its price is heavily dependent on investor whims
Commodities (other than gold)	Commodities in limited short-term supply tend to perform well during inflation. They also benefit from growth in developing countries	Tends to perform poorly in slow growth environments. (Watch out if growth slows in China.) Commodity prices are generally volatile
Real estate investment trusts (REITs)	Property offers long-term protection against inflation. REITs make it easy to buy and sell a diversified property portfolio	Real estate may be overvalued. REITs will suffer in a property downturn, or if interest rates rise when landlords can't raise rents

COMMODITIES. Historically, commodities such as metals and agricultural products have been a good hedge against inflation, though their prices can be volatile. Commodities also tend to perform poorly in slow economies, so sluggish growth in most developed countries suggests this is a poor time for these kind of investments. But growing demand from China and other emerging countries has filled the gap, allowing most commodities to thrive. People in those countries are using their rising incomes to purchase consumer goods like fridges, apartments and cars and that impact is huge, says Stephenson, author of *The Little Book of Commodity Investing*. "Seventy-five million people a year are coming into the global middle class." He believes commodities are a hedge against potential inflation, but in general, "we're in an environment I would characterize as good for commodities but not great."

'REAL ESTATE CAN PROVIDE SOME HEDGE AGAINST INFLATION, BUT IT'S NOT PERFECT'

Investing directly in commodities is mostly done through trading futures contracts, but these markets are dominated by professionals and are too complicated for average investors to master, Stephenson says. One option is to use an ETF that holds a basket of commodities futures. For the most part, Stephenson recommends commodity-based stocks: currently, he sees attractive investments in some companies producing base metals and fertilizers. He also likes Canadian heavy oil producers, which he says should benefit when oil transportation bottlenecks start to get sorted out.

Of course, you may have all the commodity exposure you need already if you are invested in the broad Canadian stock market. That's because so many Canadian stocks are commodity-related—almost half the S&P/TSX Composite Index is in the energy and materials sectors. But if you don't have a large commodity exposure already, gradually adding modest amounts to your portfolio should provide useful diversification.

REAL ESTATE INVESTMENT TRUSTS (REITS). Property is also a traditional hedge against inflation, and real estate investment trusts are a good way to get exposure to this sector of the economy. REITs own commercial, industrial and residential properties and pass a portion of their rental income along to investors, so they're attractive to retirees looking for cash flow.

But you need to consider other factors, says Leslie Lundquist, co-lead manager of the Bissett Canadian High Dividend Fund, which invests in REITs. For one thing, REITs have become so popular that yields have been bid down to a modest 3% to 6%, whereas not long ago they often yielded 8% or 9%. Most real estate values "are at the high end of average," Lundquist says.

In this environment, REITs may not provide as much inflation protection as one might think, says Lundquist. With modest economic growth, they're not expected to be able to raise lease rates aggressively in the next few years. And REITs typically have large mortgage borrowings, so if interest rates rise before landlords are able to jack up rents, REIT values may suffer for a while. "You can make the argument that REITs will provide a certain amount of inflation hedge, but that's not perfect and immediate," says Lundquist. "The immediate impact of rising interest rates is borrowing costs get higher."

Remember, inflation is only one risk your portfolio will face during retirement. It's prudent to make sure your investments have some protection from a possible inflationary scorching, but there are still other ways for your investments to get burned. Since no one knows what's going to happen for sure, maintaining a diversified portfolio that performs reasonably well in different environments is still a good idea. **M**

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