

Inflation, Deflation & Everything in Between



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By William Hammer, Jr.

A simple solution to a complex problem

In a February speech at the National Press Club in Washington, Ben Bernanke was not worried about future inflation because overall current inflation remains quite low. Ben Bernanke is not concerned about inflation, but does that mean you shouldn't be worried?

A roof is not a problem until it leaks, at which point it becomes a huge problem. Inflation is no different, but Bernanke would rather wait until the first sign of water damage to fix it.

The government policies of the last few years are likely to lead to inflation unless changes are made. It is very difficult to run this large a deficit and print that much money without these policies becoming inflationary at some point.

The obvious question then is, "What investments can protect my portfolio against major inflation?" There are a few other questions, though, that we need to answer before we make specific investments designed to hedge against massive inflation.

What's the likelihood of major inflation occurring? When will it occur? How bad will it be? How long will it last? Will the Fed be able to contain it or even prevent it?

Unless you have a fully functioning crystal ball, **you do not** and **cannot** know the answers to these questions, nor can anyone else.

Could higher-than-average inflation be coming over the next few years? Yes, it's possible, and some economists, hedge fund managers, and even Warren Buffett think it's inevitable. This is no secret, though, because we all have access to the same news headlines whether we are managing billions of dollars or a small retirement account. Therefore, **some** of this, if not **all** of this, expectation must be reflected in prices already.

At the same time, however, there are experts that are hedging against massive *deflation*. So who is right? Only time will tell. On a personal note, I will start worrying about deflation as soon as I see the U.S. Postal Service cut the price of stamps or my health insurance provider lower my premium. I'm not holding my breath.

If we do not, and cannot, know **how**, **how much**, or when major inflation will occur, how can we invest accordingly? The answer is that we have to have all of our bases covered—deflation, regular inflation, hyperinflation, and everything in between—so that our portfolios can survive whatever storm comes.

We could be correct in guessing that above-average inflation could be on the way, but it could show up earlier

or later than we think. It could also be less severe or more severe than anticipated. It could last longer than we had expected, or it could be contained quickly by the Fed.

The most sensible way to be prepared for any range of economic outcomes is also the simplest solution—**diversification**. By diversifying across stocks, bonds, and investment real estate, your portfolio can withstand a number of potential scenarios.

The main idea of investing is to protect yourself from major disasters. If you do that consistently over time, the upside takes care of itself. Diversification is the ultimate form of protection for your portfolio, since it ensures that no one country, economic environment, interest rate move, accounting scandal, oil spill, war, or poor acquisition can destroy all of your hard-earned capital.

Owning a broadly diversified, global basket of **stocks** means owning companies who have pricing power if inflation rears its ugly head. A broad cross-section of stocks will likely include energy companies who could potentially benefit from an inflationary environment.

Long-term nominal **bonds** would be great in a deflationary environment, while shorter-term bonds could be helpful in a rising interest-rate environment. Treasury Inflation-Protected Securities (TIPS), on the other hand, could also be a good way to play your inflation concerns. In fact, they would also be favorable if deflation occurred because you would eventually get par back, even though nominal bonds would have performed better.

Investment **real estate**, like REITs, is a good diversifier as well as a hedge against inflation. However, like TIPS, REITs are more beneficial if held in a qualified, tax-deferred account like a 401(k) or an IRA. Both asset classes are too tax-inefficient for taxable accounts unless you or your clients are in a very low tax bracket.

A wide variety of stocks, bonds, and real estate should be your three best amigos because they each can respond well under various scenarios. In addition, by owning a global cross-section where no one country dominates, you also keep yourself protected from the major damage of a crisis in one country like what has happened in Libya or Japan.

By diversifying, you will not make a killing from guessing right, but you won't get killed by guessing wrong. **FA**

Diversification does not assure a profit or protect against loss in a declining market.

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