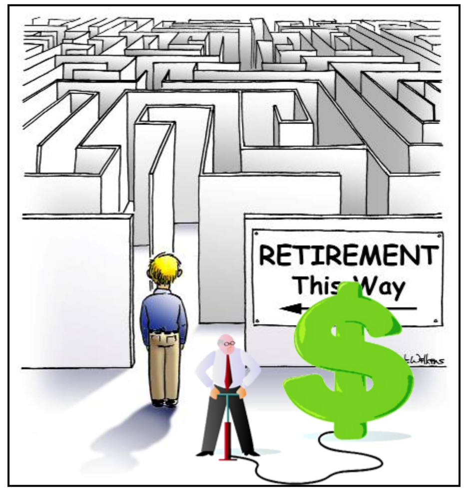
Reprinted from the *Lexington Minuteman*

COROMANDEL WEALTH MANAGEMENT

July 2013

Worried about Inflation? A few TIPS…

Navigating the Retirement Maze



Inflation is taxation without legislation.

- Milton Friedman, Nobel prize-winning economist

The recent spike in interest rates suddenly has people worried about another potential spike down the road: Inflation. As April showers beget May flowers, higher interest rates make borrowing more expensive, which increases production costs, and the higher prices eventually find their way to the consumer.

Inflation can make living on a fixed income in retirement a challenge, as the value of your portfolio may not increase as rapidly as your expenses, creating a significant erosion in purchasing power over time. 3% per year may not sound like much, but over 25 years, a dollar's buying power is reduced by more than 50%. Thus, inflation-proofing their portfolios may soon become a priority for retirees.

The best known inflation protection is Treasury Inflation Protection Securities, more commonly referred to as "TIPS." While TIPS deserve a place in most retirement portfolios, they aren't the silver bullet against inflation that many believe them to be. There are other investment alternatives available that, combined with TIPS, can make for a more robust inflation-proof portfolio.

TIPS: The Basics

TIPS are similar to U.S. Treasury bonds in that they carry a fixed yield and are guaranteed by the U.S. government. They are available in 5-, 10- and 30-year maturities. Where they differ from Treasuries is that every six months, the value of TIPS are adjusted by the increase in the Consumer Price Index (CPI). Thus, if the six-month inflation rate has been 1.5%, then a $1,000 face value bond will be revalued at $1,015, and the twice-yearly interest payment is now calculated based on the new value. To compensate for this inflation hedge benefit, TIPS are issued at a lower yield compared to similar maturity Treasuries, where the difference between the yields is the "expected inflation rate." As of this writing, the yields of 10-year Treasuries (2.64%) and 10-year TIPS (0.52%) yields an expected inflation rate of 2.12% per year.

TIPS Are Not Risk-Free

So what are TIPS' shortcomings? For starters, low current interest rates. Even with inflation indexing, you're not making much of a return on your invested money, much like other US Treasury debt. On top of that, you have the same interest rate risk as Treasuries: as interest rates increase, the value of the bonds decrease. Yes, you've got inflation protection, but interest rates and inflation don't necessarily move in tandem, so a rate increase similar to the one that we saw last month results in a loss. For example, one TIPS exchange traded fund decreased in value by 9.2% during the past two months. Increasing interest rates combined with low inflation are the worst scenario

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for TIPS. Play it safe by sticking with TIPS maturities of five years or less for now. Also, consider purchasing TIPS directly from the U.S. Treasury (www.TreasuryDirect.gov) to eliminate fund fees and reduce the volatility found in TIPS mutual funds and ETFs.

Another problem has to do with the U.S. Government calculation of the CPI. It was "improved" back in 1990, supposedly to better reflect consumer preferences, though many believe that it was done to reduce the indexing of Federal entitlement payouts. Shadowstats.com compares the two measures, and the most recent CPI figure released by the government (1.4%/year) is considerably lower than the ShadowStats pre-1990 formula calculation (4.7%/year). Thus, reported CPI growth may trail your actual inflation-related expense increases in retirement spending.

Diversify, Diversify, Diversify

We can't predict the future, and no one asset class works in all future scenarios. Thus, the safest approach is to spread your bets. In addition to TIPS, there are other assets that have traditionally gone up with rising inflation. Some of these include: real estate, precious metals, selected stock sectors (consumer staples, banks, energy, agriculture), commodities, floating rate bank loan funds, and high yield debt (a.k.a. "junk bonds").

One final inflation hedge worth mentioning: mortgages. That may seem odd, but think of taking out a fixed-rate mortgage as selling a bond to someone else (i.e., a bank). You get the benefit of a guaranteed rate, and the bank bears the risk of rising inflation and interest rates. If inflation accelerates, a low-interest loan can be a way to invest in higher return assets.

You can't prevent inflation, but you can certainly soften its blow during retirement by adding inflation-friendly assets to your investment portfolio. While inflation doesn't appear to be an imminent risk, keep in mind that the only predictable aspect of the financial markets is change.

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