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INVESTMENT STRATEGY

The Best Inflation Hedge?

A mix of holdings may beat relying only on Treasury inflation-protected bonds

By MICHAEL A. POLLOCK

As rising prices of oil and other commodities fan fears about inflation, many investors have been stocking up on U.S. Treasury inflation-protected securities or shares of mutual funds that invest in those securities.

Journal Report

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The principal value and interest payments of TIPS rise along with any increase in the consumer-price index. And, of course, Treasury debt of all kinds is considered to be among the safest of investments, an advantage over alternative ways of buffering a portfolio against inflation.

But some investment managers argue that TIPS alone aren't the ideal solution in an environment, like the current one, in which interest rates could be poised to rise significantly as inflation accelerates. That's because sharply higher interest rates would eat into the value of TIPS in an investor's portfolio.

More

TIPS vs. TIPS Funds

A better approach, they say, is to mix TIPS with other assets that also have inflation-protection benefits but won't be as sensitive to interest-rate movements. These may include such things as riskier bonds that offer yields far above the current inflation rate, and natural-resources stocks and real-estate securities, which may appreciate further as economic growth heats up.

A broader array of inflation-minded investments provides not only diversification but also potential capital appreciation, helping to reduce the risk that investors will outlive their money, says Michael Finnegan, chief investment officer at the funds unit of Principal Financial Group Inc.

Some mutual-fund firms have launched products that allow investors to get such a varied mix within a single fund. Principal Financial rolled out one such fund, Principal Diversified Real Asset, a little more than a year ago.

Unlike pure TIPS funds, whose returns may roughly match the inflation rate, many of the newer offerings aim to generate returns that exceed the rate of inflation, sometimes by several percentage points.

Dealing With Risk

Whether the recent surge in commodities prices heralds sharper increases in the cost of living remains a matter of debate. Some investment professionals believe that with unemployment high and real-estate valuations still falling, consumer-price inflation won't pose a serious threat anytime soon. But many investors aren't waiting to find out. They're looking now for ways to protect their money.

Illustration by Boris Kulikov

As with any investment approach, a strategy for inflation insurance should be tailored to an investor's circumstances and appetite for risk.

Paul Winter, a financial planner in Salt Lake City, likes a simple combination of TIPS and blue-chip stocks. He favors companies, like the oil majors, that he thinks have the power to raise prices without damaging their business. He believes that it doesn't make sense to add high-yield bonds to a portfolio right now because they already have rallied strongly, so there isn't enough potential for further gains to offset the default risk these bonds carry.

The appeal of TIPS as an inflation hedge is that they are so straightforward—they're linked directly to the consumer-price index, notes Robert Bayston, who manages a TIPS-focused offering, Dreyfus Inflation Adjusted Securities. However, pure TIPS funds carry significant interest-rate risk.

First, some explanation of the mechanics: An inflation-indexed Treasury security has a set annual interest rate—recently 0.125% on a five-year TIPS. Increases in consumer prices push up the bond's redemption value at maturity, and the semiannual interest payments increase as the fixed interest rate is applied to a growing principal value. But if interest rates in the marketplace rise, investors may begin to demand higher yields on new TIPS. And as with other bonds, those higher yields would depress the market prices of older bonds whose yields no longer look so attractive.

Because short-term TIPS yields are low, TIPS funds commonly own some higher-yielding issues with maturities of 20 years or more. Such funds often have a duration—a measure of the sensitivity of their prices to changes in interest rates—of around seven years. According to the math of bond investing, if market interest rates were to rise by one percentage point, a fund with a duration of seven years could lose as much as 7% of its principal value.

Managers of pure TIPS funds can mitigate that risk by shifting some money into shorter maturities when they believe rates could be headed higher. But some newer, more diversified funds known as "real return" funds use strategies that are designed to continually pose less interest-rate risk while generating attractive returns.

Eaton Vance Short Term Real Return can't have a duration, on average, of more than four years. The actual average duration of the portfolio is closer to two years. That's because, while about two-thirds of the fund's holdings are short-maturity TIPS, most of the rest are shares of another Eaton Vance fund that invests in floating-rate bank loans. The loans have very short durations and generate several percentage points' more yield than TIPS.

To link its loan-fund holdings to inflation, the fund uses a swap in which it pays the rate it gets on the loans to a counterparty and receives a payment matching the rise in the CPI. The fund can also seek added returns through instruments including corporate inflation-linked bonds and securities in foreign currencies, says manager Thomas Luster.

Broad Menu

USAA Real Return, which started up last October, invests in a much broader range of assets, including precious metals and emerging-markets stocks, large-cap U.S. dividend-paying stocks, real-estate investment trusts, high-yield bonds and bank-loan securities. Its largest allocation, about a third, recently was in U.S. corporate bonds, while TIPS made up about 19% of its holdings.

The fund aims for long-term returns of about two to three percentage points above inflation, with less price volatility than stocks, says lead portfolio manager John Toohey.

Principal Diversified Real Asset also holds a diverse mix, anchored by a TIPS holding of about 30%. It has exposure to commodities, natural-resources stocks, REITs and master limited partnerships, and may add bank loans, Principal's Mr. Finnegan says. Master limited partnerships are publicly traded shares of partnerships, which usually carry relatively attractive dividend yields.

The fund hopes to generate returns of around three percentage points above the rate of inflation, Mr. Finnegan says.

Although TIPS can be a worthwhile part of an investment strategy, investors need to own other inflation-sensitive assets to generate enough money for retirement, he believes. "We believe real assets should be a part of everybody's portfolio," Mr. Finnegan says.

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