



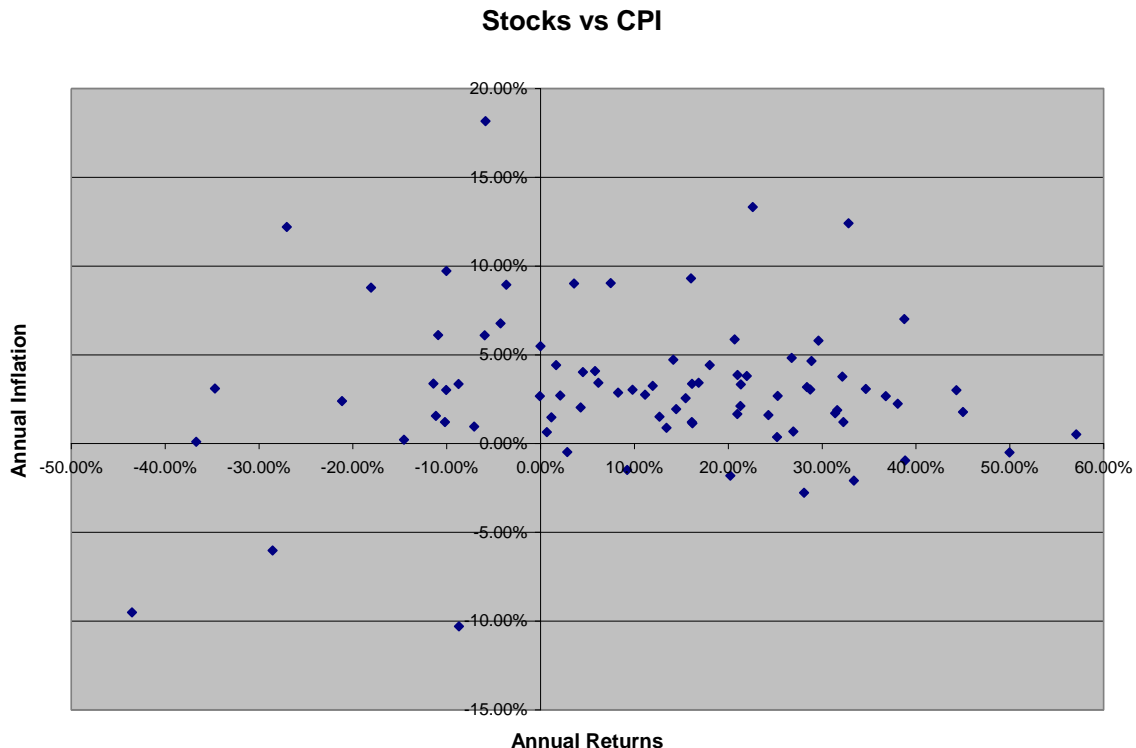
Ruminations on Hedging Inflation

While inflation is currently quiescent, there is a great deal of concern that it may reappear with a vengeance in the future. Currently the spread between nominal (“regular”) treasuries and TIPs (Treasury Inflation Protected Securities) indicates very moderate inflation expectations, but of course the situation could change given the Federal Reserve’s aggressive monetary policy. Following are some of the main ways to hedge inflation risk.

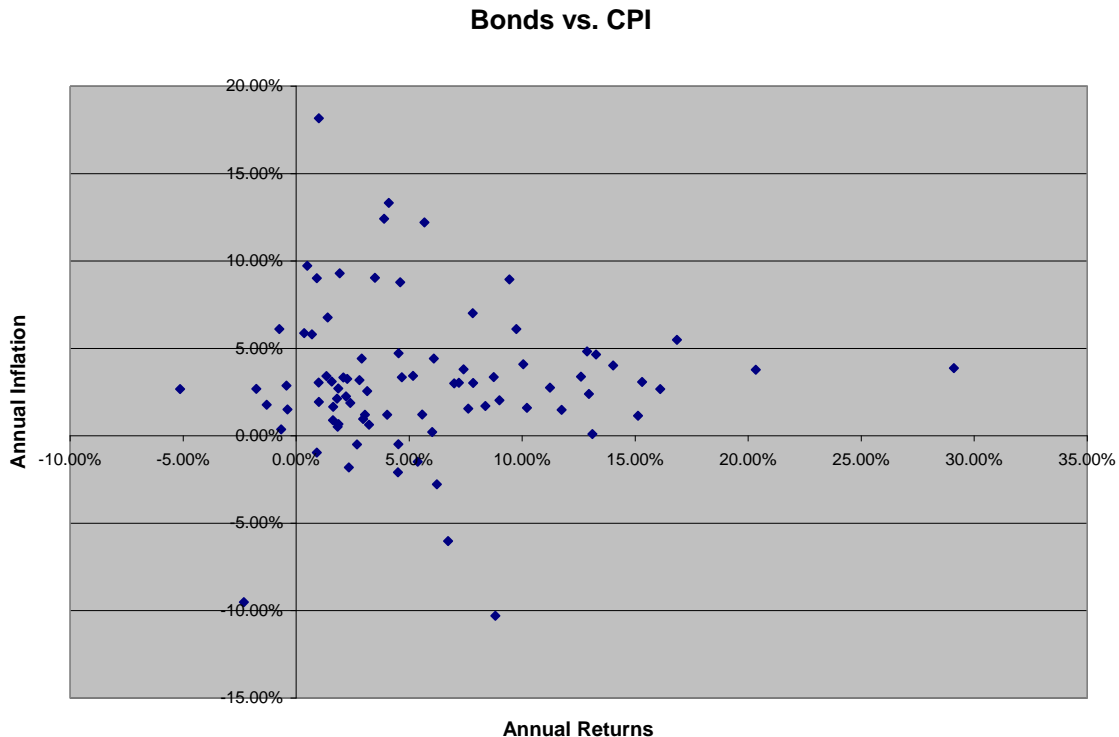
Stocks. As a claim on non-financial assets (land, equipment, brand name, etc.) stocks should maintain their purchasing power despite inflation. Since companies are net debtors, they should even benefit from inflation. Research indicates that people don’t analyze financial statements correctly in inflationary environments, and companies aren’t fully valued in that situation. Of course, the mispricing should correct in the long run. “Common knowledge” regards inflation as bad for stocks. Examining the calendar years from 1926 through 2008, we find the following annualized returns for stocks under various levels of inflation:

<u>Inflation Level</u>	<u>Total US Stock Market</u>	<u># Years</u>
Deflation	10.19%	10
Low Inflation (0-3%)	13.48%	32
Moderate Inflation (3-5%)	14.02%	24
High Inflation (>6%)	2.54%	17

The above indication that high inflation is bad for stocks is less clear when plotted on a scatter chart:



While we are looking at scatter charts, here is the same one for bonds (five year treasuries):



International Investments. U.S. inflation may be hedged by holding financial assets denominated in other currencies such as foreign stocks and bonds and *not* hedging the currency risk.

Fixed Income. There are two ways to hedge, or at least mitigate, inflation ravaging a fixed-income portfolio. First, hold TIPs rather than nominal bonds. To the extent inflation manifests in the prices of consumer goods (rather than creating a bubble in some other asset), the bond-holder is fully hedged. Second, in nominal bonds keep the duration (roughly the same as the maturity) relatively short.

Alternative Investments. Equity REITs (Real Estate Investment Trusts) can be a good inflation hedge assuming the mortgages are less flexible (longer term and more fixed rates) than the rental agreements, which would normally be the case. In addition, commodities in general should hedge inflation to some extent. The historical change in commodities prices (spot prices, not futures) is slightly under the rate of inflation because technological developments mean constant improvement in our ability to grow, extract, refine, etc. commodities.

Real Estate. For most people, their home is their largest investment. Because purchasing a home can be considered pre-paying rent with today's dollars, this is also an inflation hedge. Alternatively, a home financed with a long-term fixed-rate mortgage is an outstanding inflation hedge as well since future payments will be made with cheaper dollars.

Notes:

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