

Investment Options For Beating Inflation

**As Gold and Other Customary Havens Lose Their Luster,
A New Crop of Products Can Help You Stay Ahead**

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As energy and food prices fuel inflation, the classic hedges -- real estate, gold and Treasury Inflation-Protected Securities -- aren't providing their usual protective magic.

But investors can still find ways to guard their portfolios. A growing number of inflation-linked products, including corporate bonds, savings bonds and, for the retirement crowd, annuities can help reduce the bite as the pace of price increases picks up.

In the past, real estate was a great buffer against inflation. That's no longer the case with housing prices plunging around the country. Gold, which usually offers shelter from inflationary storms, already has had a big run-up and looks pricey. Meanwhile, inflation-adjusted yields on TIPS have plummeted in recent months. That's because investors have fled to the safety of Treasuries, which influence TIPS yields, and because of a sharp drop in interest rates. Returns on 10-year TIPS have dropped to about 1.4% from 2.5% last summer.

Certainly, inflation could shift downward, which it may well do if the economic slowdown worsens. Then the newer inflation-cushioning instruments would bring lower returns than standard investments. As a result, financial advisers generally recommend that investors park only a small portion of their portfolio, typically 5% to 10%, in inflation-insulated products.

Already, those worried about rising prices are turning to inflation-linked corporate bonds. Demand for this paper has picked up in recent months, says Tom Ricketts, chief executive of Incapital LLC, a Chicago investment bank that specializes in fixed-income underwriting for individual investors.

Two weeks ago, for example, the firm sold about \$10 million of inflation-linked five-year notes from Prudential Financial Inc. The notes pay a monthly coupon of two percentage points plus the year-over-year change in the consumer-price index, which was up 4% in March from a year earlier. So this month, the notes yield 6%, which compares favorably to the five-year Treasury note, which yields 2.96%.

Incapital is offering another inflation-protected note from J.P. Morgan Chase & Co. this week with a monthly coupon paying 1.4 times the year-over-year change in the CPI, meaning it now pays 5.6%.

Marilyn Cohen, president of Envision Capital Management Inc., a Los Angeles bond-investment firm, has been considering some five-year inflation-linked notes from Hartford Life, offering a 5.29% coupon this month.

Although inflation-linked corporate bonds still aren't as cheap as preferred stock from financial-services firms, she notes, "They are bargain basement compared to TIPS. ... Buying inflation-indexed corporates is like shopping in Filene's compared to shopping in Neiman Marcus."

Certainly, some corporate preferred stock, particularly from beleaguered banks, is even cheaper and yields more. And there aren't a lot of inflation-linked corporate bonds available, so investors may not find them easy to buy or sell. Though the bonds are subject to default, they're more protected than preferred shares in the event of a bankruptcy, and they will track inflation, no matter what. Investors are likely to see more offerings come to market as concerns over inflation increase, Ms. Cohen says.

Want something with zero risk of default? The federal government offers an instrument that currently has a better payout than yields on many TIPS. That's a savings bond called the I Bond, which got a boost as a result of last week's CPI report. Starting May 1, yields on new I Bonds are likely jump to more than 5% from the current 4.28%, based on the March CPI report.

But act now on I Bonds, whose payout combines a fixed rate and an inflation-tracking rate. Investors who snap up I Bonds before the end of the month will be able to lock up a better return. New I Bonds issued after May 1 likely will yield less. The Treasury Department is expected to lower the fixed rate on new I bonds to 1% or less from the current 1.2%, given a general decline in Treasury yields.

For those on the brink of retirement, a new breed of immediate annuity is available to shield them from inflation. With an annuity, people pay a lump sum upfront and draw payments until they die. The problem is that, over decades of retirement, that fixed payment can be eaten away by inflation.

The new inflation-linked annuity bumps up the payments every year, to track the inflation rate. So far, just a few companies offer this alternative, notably Vanguard Group Inc., New York Life Insurance Co. and, for 401(k) plans only, **MetLife** Inc. Vanguard's annuity, called the Lifetime Income Program and underwritten by **American International Group** Inc., adjusts payments every year according to any CPI increases. If the CPI moves down, the payout doesn't go down with it. The others let policy holders choose how much extra they want to get paid annually, from 1% to 5%. Vanguard has that option, too.

Still, inflation-linked annuities haven't been very popular -- just 10% to 15% of Vanguard annuity buyers opt for these products -- which explains why only a few firms offer them. The main reason for the low demand is that initial payments are lower than those for a standard annuity. A 65-year-old male who invests \$100,000 in a traditional annuity gets

\$781 as his first month's payment, versus \$590 from the inflation-adjusted one, according to a Vanguard calculator. Holders of inflation-linked annuities pull ahead only if they live longer than their expected life spans.

"If the maximum payout is your biggest focus, you don't want to buy an inflation-protected annuity because that's going to reduce your payout on Day One," says John Heywood, a principal at Vanguard.

Commodities, of course, are a longstanding inflation buffer. The price of gold is up 35% in the past 12 months. Prices for most other commodities, from crude oil to corn, have also climbed sharply. The question is whether they will keep rising. Odds are, if inflation moves higher, they will too.

Inflation-Proofing Your Portfolio				
Typical hedges against inflation aren't looking attractive, but there are other inflation-linked products to try:				
Product	What It Is	Pros	Cons	How to Buy
Corporate inflation-linked securities	A corporate bond that generally pays monthly interest adjusted to changes in the consumer-price index	Offers higher yields than comparable Treasuries and, unlike TIPS, adjusts monthly for inflation increases	Investors carry the risk of the company issuing the bonds. Also, the market for these bonds is still relatively small.	In increments of \$1,000 through Incapital LLC and major brokerage firms
I Bonds	A government savings bond that earns interest monthly, based on a fixed rate, plus a semiannual inflation adjustment; investors receive interest only when they cash in the bonds	They are ultrasafe, like Treasuries. Plus, they offer tax breaks if used for college payments, depending on the owner's income and other restrictions.	Investors generally can't cash in the bonds in the first year after purchase. If they redeem the bonds within five years, investors forfeit the most recent three months of interest.	From TreasuryDirect.gov, most local financial institutions or through payroll deductions; minimum purchase is \$50 for a paper bond and \$25 for the electronic form
Inflation-linked annuities	Annuities that increase payouts every year, based on either inflation or a percentage chosen by the investor	As investors get older, they get a payout that keeps pace with inflation.	Initial payments are much lower than classic annuities	Companies like Vanguard Group and New York Life Insurance offer these directly, while others, like MetLife, offer them through 401(k) programs.

Lately, it has become easier for individuals to invest in commodities, thanks to a growing number of mutual funds, exchange-traded funds and debt investments called exchange-traded notes. Investors can get exposure to futures ranging from nickel to grains to livestock through ETFs and ETNs. Financial planners advise caution in buying single commodities, as they can be very volatile.

Matthew Tuttle, a financial planner in Stamford, Conn., prefers a diversified fund like the Van Eck Global Hard Assets Fund or the Pimco CommodityRealReturn Strategy Fund, which tracks the Dow Jones-AIG Commodity Index and invests in TIPS. Is it too late to get in? Mr. Tuttle doesn't think so. "I think we're in a long-term bull market for commodities," he says.

Another approach is to use mutual funds that invest in stocks of commodity companies. That's the advice of Don Martin, a planner in Los Altos, Calif. One such prominent fund is the T. Rowe Price New Era Fund, which is mostly invested in oil-related companies like ExxonMobil Corp. and Diamond Offshore Drilling Inc.

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