Inflation and its impact on your investment portfolio

Understand and take action to guard against inflation-related risks. TEH SHI NING reports

Inflation is "as violent as a mugger, as frightening as an armed robber, and as deadly as a hit man," Ronald Reagan once said. But he spoke as a US president with a double-digit inflation rate to tackle, and inflation's creeping effect on wealth is probably less alarming to the average investor, who can take early action to guard against inflation-related risks.

Understanding Inflation

Inflation is a general increase in prices, commonly measured by the year-on-year hike in the consumer price index (CPI).

For instance, the 5.7 per cent inflation rate reported for the month of August reflects the 5.7 per cent increase in the prices of the CPI basket's commonly purchased consumption goods and services from August last year. The CPI (which stood at 103.6 in August 2010 and 109.5 in August 2011) captures price movements and not actual price levels. So the rate of growth of prices, or what inflation is, is important. And an investor can purchase fewer units of a dollar today buys you less than it did a year ago. And for many investors, this is a key push to invest, as interest rates on savings accounts lag behind wealth-eroding inflation.

There are nuances worth appreciating. As a general measure of price levels, the percentage change in the CPI may not reflect changes in the out-of-pocket spending of the majority of consumers. Spikes in car COE prices and imputed rental costs for instance, played a large role in keeping Singapore's inflation elevated most of this year. Inflation is now expected to slow towards year-end.

High inflation – good or bad?

In periods of high inflation, long-term fixed-income investments like bonds usually suffer most, says Nanyang Business School assistant professor of finance Stephen Dimmock. "Fixed income investments, given their fixed coupon rates, perform the worst during inflationary periods," he says.

For equities, the impact of inflation is often temporary. Stock prices may fall initially as inflation rises, but in the long run, equities may maintain their value as companies "can raise prices and increase nominal earnings to offset the effects of inflation," Dr Dimmock says.

The effectiveness of holding common shares to hedge against inflation, depends on the extent to which companies can pass rising costs on to customers. Those able to do so – like the airlines do via fuel surcharges when oil prices spike – are those whose "shares may provide a better hedge against inflation," says NUS Business School senior lecturer of finance Ravi Jain.

NUS Business School senior lecturer of finance Ravi Jain agrees. Though equities typically do not perform when inflation is high, dividend-paying stocks in defensive sectors such as utilities, telecoms, pharmaceuticals, healthcare, basic materials and consumer staples, tend to hold up better in times of low growth and high inflation.

Real estate properties and commodities investments track inflation better than common shares, so demand for these tends to rise during periods of inflation, says Mr Koh.

As for commodities, surges in inflation tend to be accompanied, or driven, by higher prices of natural resources like oils, metals and food products. "Historically, commodities have offered solid protection against inflation," says Mr Jain.

Guarding against inflation

"These are very uncertain times and there is a lot of disagreement among market participants about what the future will hold in terms of global growth, inflation, interest rates, unemployment, currency movements, international trade and political risks," he says.

"But if an investor expects inflation to remain high, he may wish to reallocate his portfolio to mitigate inflation risks," Mr Jain adds.

Given how rising prices affect the different investment categories, it would be prudent for investors to "reduce their investments in fixed-income instruments such as deposits, money market instruments and fixed-coupon bonds during periods of high-inflation," Prof Koh says.

Persistent inflation often heralds the rise of interest rates, which means that the value of fixed-income instruments, particularly those with long maturity periods, will depreciate most in the long-run.

There is also the option of purchasing instruments whose payoffs are explicitly tied to inflation. While bonds tend to perform poorly when the interest rate is high, some countries have introduced special bonds that provide protection against inflation. "These include the recently issued US Treasury Inflation Protected Securities (TIIPS) issued by the US Treasury," Mr Jain says.

He notes, however, that Singaporean investors must be aware that the returns of such bonds are linked to the inflation rate in the bonds' home countries, which may differ greatly from Singapore's inflation rate. These bonds are also denominated in other currencies.

Holding investments denominated in various currencies may help take advantage of inflation, adds Dr Dimmock. "High inflation in a country usually results in currency depreciation – that is to say, the currency of a country with high inflation can purchase fewer units of foreign currency," he says.

An investor who holds foreign assets denominated in a foreign currency may receive, on top of the assets' investment return, additional returns as the foreign currency becomes more valuable relative to the local currency.