

# PHILADELPHIA BUSINESS JOURNAL

Friday, July 24, 2009

## On the Lookout for inflation

Philadelphia Business Journal - by [Peter Key](#) Staff Writer

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An economic recovery may still be a while in coming, but when it does, it could bring inflation with it.

This may be a good time to become familiar with investments that offer protection against inflation, even if taking advantage of them immediately isn't necessary.

"The probability of facing inflation is higher than it has been in the recent past, so it is something that investors should perhaps consider," said Edward Nelling, a fellow in the Center for Corporate Governance, which is part of Drexel University's LeBow College of Business.

The economic-stimulus package passed earlier this year authorized \$787 billion of federal spending. Altogether, the Federal Reserve said in March it would put \$1.75 trillion into the economy by also

buying back up to \$1.25 trillion of mortgage-backed securities, up to \$300 billion of treasury bonds and up to \$200 billion of other agency debt.

So far, the Fed's actions not only haven't spurred inflation, they haven't boosted the economy much, either. That's because banks are largely sitting on the money, said Kenneth Kopecky, chairman of the department of finance in Temple University's Fox School of Business

"During the Great Depression, the same thing happened. Bank reserves exploded in size; banks didn't lend," Kopecky said.

The concern, however, is that when banks start to lend, the Fed won't be able to undo what it has done quickly enough to stop inflation from taking hold.

So even though inflation is unlikely to pose an immediate problem, some financial advisers are beginning to help their clients prepare for it.

**KB Financial Partners thinks inflation is a significant risk in the long term, but not as much of a risk in the short term, said Erik Mosholt, chief financial officer for the wealth-management firm, which has offices in Newtown, Princeton and Point Pleasant Beach, N.J.**

**But KB thinks prices could rise if the dollar continues to weaken due to the Fed's actions and concern over the size of the federal deficit.**

**As a result, Mosholt said, the firm has begun to take minimal to modest positions in investments, such as commodities, that protect against inflation in its clients' portfolios.**

**"We've also been a little more aggressive in diversifying into non-U.S. dollar currencies through both direct currency products as well as increased exposure to foreign stocks and bonds," he said.**

Investors who don't want to directly buy gold or other commodities can invest in companies whose fortunes are tied to commodities, such as mining and agricultural companies.

They also can buy exchange-traded funds that buy commodities or that seek to mirror the value of commodity indexes.

The most basic step to protect against inflation is reducing — or avoiding — investments in long-term bonds or long-term bond funds.

Long-term bonds usually pay higher interest than short-term bonds because they are considered riskier. One of their risks is that their rates could wind up low compared to rates of newer bonds if interest rates in general rise. As a result, the premium they offer over investments with shorter terms may not be enough to justify holding them when consumer prices rise.

"Oftentimes, investors are lured by an incremental yield ... that doesn't compensate them fairly for the additional risk," said Mark Luschini, the chief investment strategist for Philadelphia-based financial services firm Janney Montgomery Scott LLC.

Of course, the opposite can happen with investments in short-term debt, such as treasury bills, or funds that invest in it, such as money-market funds.

Investments in short-term debt aren't a big problem when rates rise because it pays its principal back quickly so the money can be invested in new short-term debt with a higher rate. And the rates paid by money-market funds rise when rates in general rise, so they also can be a good hedge against inflation.

The problem with both short-term debt and money-market funds, however, is that the rates they pay aren't very high, so investing heavily in them pretty much guarantees a low return.

Another option is to invest in Treasury Inflation-Protected Securities, or TIPS, which are notes and bonds issued by the Treasury Department that adjust their face value according to the Consumer Price Index.

The way they work, in a year in which the CPI rises 2 percent, the face value of TIPS rise 2 percent also. So TIPS that started the year with a \$1,000 face value would end it with a \$1,020 face value.

The increase in a TIPS' face value also has the effect of boosting its interest payments, which are made every six months, since they're calculated as a percentage of its face value.

That makes TIPS a great inflation hedge, since their interest payments, as well as value of their principal, will rise with the CPI.

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