MAKING YOUR MONEY LAST

Retirees, Prepare Your Nest Egg to Fight Inflation

Workers have a natural hedge against rising prices because wages tend to rise with inflation. But once you retire, "this insurance is gone," warns a financial planner.

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By ELEANOR LAISE, Senior Editor
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Inflation doesn't look like much of a threat at the moment. But for retirees, it's a risk that can't be ignored.

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Late last year, rising commodity prices, a tightening labor market, and a new administration voicing support for tax cuts and infrastructure spending all fueled growing concern over rising prices. The consumer price index started to tick up in August of last year, and in February it posted a 2.7% year-over-year increase, the largest in five years.

But then came four straight months of decelerating inflation. The CPI climbed just 1.6% in the 12 months ending in June. **Kiplinger sees inflation at 1.3% at the end of this year**, down from 2.1% in 2016.

So why worry about inflation now? The real concern is that an inflationary shock—an unexpected spurt of rising prices—would be particularly damaging to investors' portfolios right now, says Ben Inker, head of asset allocation at money-management firm GMO.

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The reason: Current stock and bond valuations reflect the market's assumption that short-term interest rates will remain low indefinitely, he says. If inflation spikes, the Federal Reserve would be forced to raise rates much more aggressively than the market expects, Inker says, driving stock and bond prices south.

And for retirees, even a seemingly benign inflation rate of 2% can be damaging. If you are still working, you have a natural hedge against rising prices because wages tend to rise with inflation. But once you retire, "this insurance is gone," says Ann Minnium, a financial planner in Scotch Plains, N.J. She tells her clients that even at 2% annual inflation, "a third of their purchasing power is going to be eroded in 20 years," Minnium says.

Tools to Hedge Against Inflation

Many financial advisers try to beat inflation in retirees' portfolios by maintaining a hefty stock allocation, on the theory that stocks will grow enough to keep up with rising prices. But a big dose of U.S. large-company stocks alone won't do the trick; you need a mix of small and large, U.S. and foreign holdings.

In a recent study, Utah Valley University financial-planning professor Craig Israelsen compared the performance of various asset classes in low- and high-inflation years from 1970 through 2016. U.S. large-company stocks delivered a seemingly impressive 10.8% average return during high-inflation years—but their average after-inflation "real" return during those years was just 4.7%. U.S. small-company stocks looked better during high-inflation years, delivering average real returns of 6.3%.

When diversifying globally, consider an allocation to **emerging-markets stocks**. "Right now, emerging-market equities are significantly safer in an unexpected inflation environment than U.S. equities," Inker says, in part because they're much cheaper.

Treasury inflation-protected securities, whose principal is tied to inflation, are another good, but not perfect, inflation-fighting tool. TIPS are vulnerable to rising rates—when rates rise, bond prices fall. One way to minimize the risk: Choose a short-term TIPS fund with less interest-rate sensitivity, such as **Vanguard Short-Term Inflation-Protected Securities** (**VTIP**) exchange-traded fund. The Vanguard ETF is one of the cheapest funds in the category, with fees of 0.07%, and it focuses on TIPS maturing in less than five years.

Commodities can be inflation superstars. Israelsen found that they delivered real returns of 15.1% in high-inflation years. The **Harbor Commodity Real Return Strategy** fund (**HACMX**) offers commodity and TIPS exposure and charges 0.94%.

But again, commodities are no magic bullet. They'll likely perform admirably if we see inflation that's driven by a commodity shock like the 1970s oil crisis, Inker says, but "it's possible to have inflation that's not driven by a commodity shock," in which case commodities may not perform particularly well.

Spread your inflation-hedging bets. A multi-asset inflation-fighting fund can help. For example, **Pimco All Asset** (**PASDX**) holds a mix of commodities, emerging-markets stocks and other assets.

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