



## Market Analysis, Research & Education

A unit of Fidelity Management & Research Company

# Real Return Strategy: Hedging Against the Risk of Higher Inflation

Although the nation's aggregate level of inflation is currently low, recent government efforts to jumpstart the U.S. economy and stem the credit crisis have fueled expectations of higher inflation among some investors. The following article provides context on the potential for higher levels of future inflation, explains how inflation affects an investor's portfolio, and identifies certain assets that could allow investors to achieve a compelling "real return"—meaning the actual return after factoring in the rate of inflation.

### Do Recent Government Actions Raise the Prospects for Higher Inflation?

At present, inflationary pressures are scarce. The brutal global financial and economic crisis that began in the fall of 2008 provoked a massive decline in asset and commodity prices. Changes in consumer prices in most countries have flattened or turned negative

in recent months, making deflation—falling prices—a bigger near-term threat than inflation. Recognizing the potential for deflationary forces to gain self-perpetuating momentum, policymakers around the world have implemented a series of unprecedented actions. Central banks in most countries have aggressively slashed interest rates, while the Federal Reserve (Fed) and others have pursued extraordinary quantitative easing measures.<sup>1</sup> Further, many governments have enacted large economic stimulus programs (e.g. the U.S. government's recent \$787 billion spending legislation), and offered massive guarantees of bank deposits and certain financial institutions.

Some investors are concerned, however, that the lingering effects of these reflationary government policies will lead to an outbreak of higher inflation once they succeed in stabilizing the global economy and financial system. As the deflationary pressures abate, the Fed and other central banks will need to reverse the flood of liquidity and rapid expansion of the money supply to keep prices under control [Note: inflation generally occurs when too much money is chasing too few goods and services]. In addition, with many governments facing large current or expected fiscal deficits, there may be a temptation in the future to allow higher inflation to make servicing debt less costly. While these factors do not necessarily pre-ordain an outbreak of 1970s-style inflation rates, they do present the potential risk that inflation may become a bigger factor in the years to come.

### How Does Inflation Affect an Investment Portfolio?

#### *Inflation erodes purchasing power*

One key aspect of inflation is that it reduces the purchasing power of money. Since 2000, the average annual rate of U.S. inflation has been about 3%—considered a reasonable level for a developed economy. But during other periods, such as

#### KEY TAKEAWAYS

- While inflationary pressures are currently muted in the United States, aggressive monetary and fiscal actions have raised the prospect for higher inflation in the coming years.
- Inflation erodes a portfolio's purchasing power, and historically has caused some major asset classes, such as stock and bonds, to underperform their historical averages.
- Certain assets, such as commodities, generally perform well during inflationary periods, as do debt securities that adjust to the rate of inflation, such as Treasury Inflation-Protected Securities.
- Diversifying a portfolio with some exposure to these "real return" assets may help investors achieve some protection against the risk of potentially higher future inflation.

the 1970s, inflation averaged about 7%. The rate of inflation during any given period represents an investor's "hurdle" rate—the minimum investment return required to maintain the same level of purchasing power. If an investor expects the inflation rate to be higher in the future, a higher investment return will be required to maintain or increase the purchasing power of a portfolio (see Exhibit 1, below).

***Inflation typically no friend to stocks or bonds***

Periods of high or rising inflation have had negative implications for the U.S. stock and bond markets. In particular, stocks typically perform poorly because rising inflation is often accompanied by rising interest rates. Higher rates increase the borrowing costs for corporations, can serve as a drag on profits, and cause stock valuations to decline (as investors discount expected future corporate earnings). Meanwhile, bonds have suffered during inflationary periods due to the inverse relationship between bond prices and their yields: when interest rates (yields) rise, bond prices fall. In addition, if inflation accelerates, the coupon payments from bonds are worth less because the net effect of higher inflation is that it erodes the "real" yield from a bond.

**Identifying Assets That Tend to Respond Well to Rising Inflation**

Understanding the concept of real return investing—striving for returns that outpace the rate of inflation—is critical to ensure investors achieve

performance results that maintain and improve their standard of living. Because most financial assets, including the majority of stocks and bonds, tend to underperform their historical averages during an inflationary environment, investors may want to consider allocating a portion of their portfolios to other types of assets that may provide some element of protection from inflation.

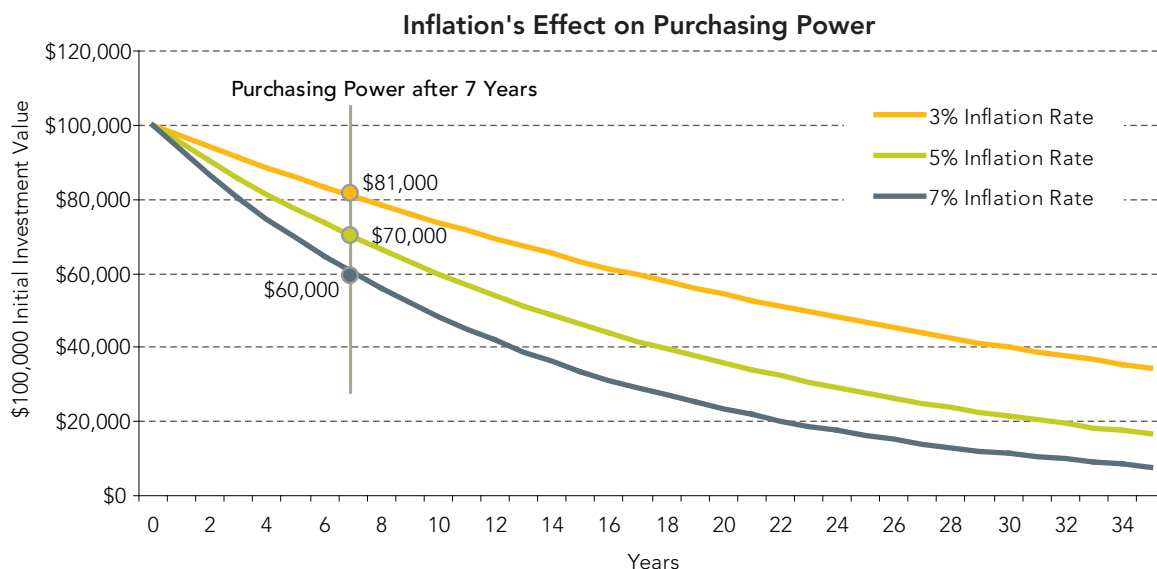
There are two broad categories of asset classes that historically have tended to hold up relatively well during inflationary climates: real assets and financial securities that adjust their return for inflation.

**Real Assets**

Real assets are tangible materials or actual property that can be expected to maintain (or increase) value even if the value of financial assets depreciates as a result of inflation. One type of real asset is a commodity, such as crude oil, timber or gold. Commodities are a common hard asset vehicle used by investors to buttress their portfolios during inflationary environments. For example, during the 1970s, when inflation rose sharply, a diversified basket of commodities performed quite well relative to other assets, such as U.S. stocks (see Exhibit 2, page 3). More specifically, when inflation peaked in 1980, the nominal price of gold bullion hit its highest level ever.<sup>ii</sup>

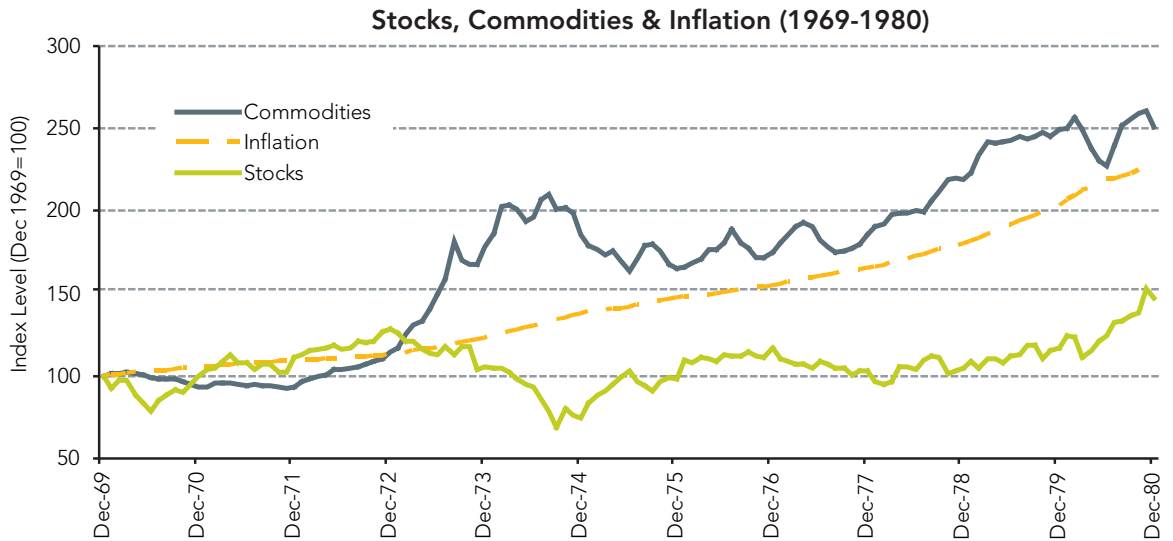
Another source of real assets is commercial real estate—apartment buildings, office towers and

**EXHIBIT 1:**  
The higher the rate of inflation, the faster it erodes the purchasing power of a portfolio.



The above exhibit is hypothetical and for illustrative purposes only. Past performance is no guarantee of future results.

**EXHIBIT 2:**  
A diversified index of commodities outpaced both U.S. stocks and rising inflation during the 1970's.



Commodities - CRB Spot Commodity Price Index; Inflation - Consumer Price Index; Stocks - S&P 500 Index. Past performance is no guarantee of future results. You cannot invest directly in an index. See footnotes for important index information. Source: Commodity Research Bureau, Bureau of Labor Statistics, Standard and Poor's, Haver Analytics, FMRCo (MARE) as of 12/31/1980.

shopping malls—which can be owned by individual investors through real estate investment trusts (REITs). Because REITs generally own physical structures and property that maintain value during inflationary periods, they tend to be less influenced by rising inflation than paper-based monetary assets.

***Inflation-Adjusting Debt Securities***

In a climate of accelerating inflation, certain financial securities can be attractive because they are structured to provide returns that adjust for inflation. U.S. Treasury Inflation-Protected Securities (TIPS), first issued in 1997, are Treasury bonds whose principal value is adjusted semi-annually based on the movement in the federal government's Consumer Price Index (CPI), a widely quoted measure of inflation. The coupon rate for TIPS is constant, but generates a higher level of interest when the inflation-adjusted principal rises, thus protecting the holder against inflation.<sup>iii</sup> The inflation-adjusted principal value of TIPS is paid by the Treasury at maturity, when the securities are redeemed. Thus, while increasing inflation will erode the "purchasing power" of the yield on a nominal bond in the face of rising prices, an investor in TIPS will receive a return that adjusts to the rate of inflation.

Floating-rate loans are another type of security that helps provide some protection against rising rates and inflation. A popular example of this type of

security is a leveraged loan, which is a securitized bank loan of a non-investment-grade company whose coupon "floats." The coupon rate is set at a premium over a going market interest rate for money (such as the London InterBank Offered Rate (LIBOR), and thus will tend to rise if market interest rates rise. If interest rates rise due to an increase in inflation, investors in floating-rate loans gain access to a higher yield as inflation accelerates.

**Investment Implications**

Combining real-return assets with other major assets, such as stocks and bonds, in the context of a diversified portfolio may help provide some protection from potential increases in the future rate of inflation. On a year-to-date basis, the prices of assets that tend to perform well amid high inflation have fallen to significantly lower levels (REITs), others have stabilized (commodities), and still others (gold, floating-rate loans, TIPS) have risen, as some investors have sought out inflation protection for their investment portfolios.<sup>iv</sup> Investors looking to increase their portfolio exposure to these types of assets may want to consider adopting a diversified approach. Building positions gradually in a basket of multiple, non-correlated assets that historically have offered some protection against accelerating or high inflation may help reduce the performance volatility that could arise over the short term in any single category. ■

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[i] Quantitative easing: Refers to the creation of a predetermined amount of new money by a central bank, which is injected into the private banking system with the hope that banks will boost lending and stimulate economic growth. Quantitative easing policies are often pursued as a measure of last resort, after a central bank has already cut its target interest rate to zero (or near zero), and interbank lending has remained sluggish.

[ii] At the end of March 2009, the price of gold (\$928 oz.) was still within range of its nominal all-time high of \$1011 oz. reached in 2008. However, on an inflation-adjusted basis, gold stood well below its peak reached in 1980 (\$2321 per oz.). Gold bullion: London gold bullion PM fix price. Source: FMRCo, MARE.

[iii] The inflation-adjusted principal value of TIPS is paid by the Treasury at maturity, when the securities are redeemed at the greater of their inflation-adjusted principal amount or the principal amount of the securities on the date of the original issuance.

[iv] Year-to-date (YTD) performance for 2009 through 4/29/09: Gold, 2.3% (Gold futures 6-month contract settlement price); TIPS, 4.2% (BC TIPS Index); Commodities, 7.1% (CRB Spot Commodity Index); Floating Rate, 20.0% (S&P/LSTA Leveraged Performing Loan Index); Real Estate, -10.9% (NAREIT Equity-Only Index). Source: Haver Analytics, FMRCo (MARE) as of 4/29/09.

All indices are unmanaged and performance of the indices include reinvestment of dividends and interest income, unless otherwise noted, are not illustrative of any particular investment and an investment cannot be made in any index.

The S&P 500<sup>®</sup>, a market capitalization-weighted index of common stocks, is a registered service mark of the McGraw-Hill Companies, Inc. and has been licensed for use by Fidelity Distributors Corporation.

The Barclays Capital (BC) TIPS Index represents an unmanaged market index made up of U.S. Treasury Inflation Linked Index securities.

The National Association of Real Estate Investment Trusts (NAREIT) Equity Index is a market-value-weighted index based upon the last closing price of the month for tax-qualified REITs listed on the NYSE.

S&P/LSTA Leveraged Performing Loan Index Standard & Poor's/Loan Syndications and Trading Association Leveraged Performing Loan Index is a market value-weighted index designed to represent the performance of U.S.dollar-denominated institutional leveraged performing loan portfolios (excluding loans in payment default) using current market weightings, spreads and interest payments.

The Commodity Research Bureau (CRB) Spot Commodity Index is an unweighted geometric mean measure of price movements of 22 commodities.

Floating rate loans are subject to restrictions on resale, price changes, and greater risk of default. REITs are affected by changes in real estate values or economic conditions, which can have a positive or negative effect on issuers in the real estate industry. Commodity-linked investments may be affected by overall commodities market movements and other factors that affect the value of a particular industry or commodity. Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

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