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The Financial Planning Newsletter

Inflation, Is it Heading Our Way? What's A Person to do About It? While the struggling economy has put a vice on inflation, experts and non-experts alike do not expect things to stay this way for much longer. Why? Many economic experts fear the current level of federal spending will inevitably lead to printing more money, and that's regarded as an inflationary solution.

As of late August, the federal deficit was estimated at $1.58 trillion and expected to increase roughly $1 trillion *more* based on the final size of the new healthcare plan. Even if inflation moves slowly, it's not a bad idea to start thinking about some savings, spending and investment strategies that take inflation into account.

What follows are a few ideas for every investor to consider, if inflation is particularly worrisome.

Refinancing, does it makes sense for you?: Earlier this month, the *Wall Street Journal* reported mortgage rates were at 60-year lows. While mortgage rates have bounced around in recent months, an economic recovery may mean rates are headed up.

Some critical areas to review when refinancing go beyond the interest rate. Ideally, looking at the total cost of the new loan versus the old loan makes the most sense. Unfortunately, it is way too easy to focus on the interest rate while forgetting the closing costs, the new term, and the impacts of taxes on the overall picture.

Consider laddering CDs and other interest-bearing savings vehicles: As we have often discussed in the past, your emergency fund should be liquid enough to access at any time. For emergency funds and other forms of savings, a rising rate environment may actually be a good thing.

One way to take advantage of the rising rate environment is through a process known as "Laddering." "Laddering" means buying CDs, T-bills or other similar investments with staggered maturity dates so the investments become available on a series of dates in the future. As the cash becomes available, it can be re-invested in similar investments, now with higher interest rates. Doing this on a consistent basis allows you to have cash available when needed and lets you take advantage of rising interest rates.

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Think of laddering as the steps of a ladder. The process allows a saver to redeposit CDs, interest bearing notes, T-bills, corporate bonds or any other investment with a fixed maturity date into something else that pays a little more as interest rates rise.

When considering inflation fighting tools, investors should be looking for investments with a high correlation to inflation. This means the investment should have a high return as inflation goes up. Unfortunately, for most investors, their stock and bond portfolios have low correlation with inflation. So are there asset classes with high correlation to inflation? Yes, of course there are. TIPS is the primary example of an asset class that correlates well with inflation. There are a number of other asset classes with good correlation with inflation. The Table at the end of this topic shows what we're talking about.

We'll not go through each of the asset classes in the Table, because each has its own advantages and disadvantages due to other factors besides inflation. For example, what might seem like a great inflation fighter, Bank Loans was an asset class that melted down with the rest of the stock market in 2008. So, while a good inflation fighter, the bank loan asset class may not be a true diversifier.

Another asset class worthy of consideration is the commodities class. This is where you'll find gold, other precious metals, and industrial materials. With the price of gold hitting new highs nearly every day lately, it may already have priced in any near term inflation effects.

What About TIPS?: Treasury Inflation-Protected Securities (TIPS) are Treasury securities whose principal and coupon payments are indexed to inflation based on the movements of the Consumer Price Index. Like ordinary Treasury securities, TIPS have a fixed coupon interest rate but principal is adjusted to reflect the inflation rate. If inflation goes up, the amount of principal to be paid at maturity rises. Coupon payments rise along with the principal since the rate is calculated on the principal amount. If your bet goes wrong and there's deflation, you won't lose your principal. There's a floor at par. When rates rise, TIPS lose value, but they tend to lose a little less because of inflation protection. It might be best to own TIPS in an IRA or other tax-advantaged account because the periodic inventory adjustment is subject to federal ordinary income tax at intervals before the bond matures.

TIPS are issued in terms of 5, 10, and 30 years. The 30-year TIPS isn't offered in Legacy Treasury Direct, but is available in TreasuryDirect. When buying TIPS, the interest rate on a TIPS is determined at auction. TIPS are sold in multiples of $100, and the minimum purchase is $100. TIPS are issued in electronic form so you won't actually receive a certificate. You can hold a TIPS until it matures or sell it in the secondary market before it matures. The price you receive in the secondary market will depend to a great extent on interest rates. If rates are rising above the rate you hold, then it's very likely you'll receive less in the sale of your TIPS than your purchase price. In a single auction, an investor can buy up to $5 million in TIPS by non-competitive bidding or up to 35% of the initial offering amount by competitive bidding. When it comes to bidding, check with your bank or broker since only they can handle competitive bids.

I-Bonds might be right for some investors: This seems to be the i-generation. We have ipods, iphones, and lots of other i-stuff. Now, we have popularized the Series I-Bonds (although I Bonds were introduced in 1998). Series I Savings Bonds, also issued by the U.S. Treasury, might be worth considering after rates finally head upward. I-bonds are sold with a fixed interest rate, which never changes, plus an inflation adjustment. It's a good idea to buy them when the announced fixed rate is high, because you'll be guaranteed that fixed return over the life of the bond plus any additional inflation adjustments later. The fixed interest rate at issuance guarantees a minimum return, plus any benefits from future inflation adjustments.

Unlike other bonds, purchases of I-Bonds are limited to $10,000 per year per investor. So in addition to investing in your name only, you may be able to buy I-Bonds under the name of your spouse, your trust accounts and in the name of your children. Before you start buying, it might be a good idea to talk to your tax professional about the potential tax impact upon redeeming them.

So there are a number of steps each of us can take to help us through inflationary times. The really good news is the steps outlined above are not detrimental if inflation remains tame.

Table 1. Quarterly Correlation of Returns to US Inflation, January 2002–March 2009

Asset Class	Index	Correlation
Bank Loans	Credit Suisse Leveraged Loan USD	0.66
Commodities	DJ UBS Commodity TR USD	0.63
High Yield	BarCap US Corporate High Yield	0.39
Convertibles	ML Convertible Bonds All Qualities	0.39
Private Real Estate	NCREIF Property	0.39
REITS	FTSE NAREIT All REITs	0.19
TIPS	BarCap Gbl Infl Linked US TIPS TR USD	0.21
Local Currency EM	JPM ELMI+ TR USD	0.20
Infrastructure	S&P Global Infrastructure TR USD	0.17
Equities	IA SBBI S&P 500 TR USD	0.15
Timberland	NCREIF Timberland	-0.31
Core Fixed Income	BarCap US Agg Bond TR USD	-0.48

Source: Research Affiliates, based on data from Morningstar Encorr.

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<u>Military Spouses Resident Relief Act:</u> Just in for tax year 2009, a spouse will not acquire or lose a residence or domicile for purposes of income tax or personal property tax by reason of being absent or present in a state solely to be with the service member serving in compliance with military orders.

Income for services performed by a spouse will not be deemed income earned in a state if the spouse is not a resident or domicile of the state in which the income is earned because the spouse is in the state solely to be with the service member serving in compliance with military orders.

The best part of this new law is it is effective for 2009 (yes, that's right 2009!) tax returns. I know the state residence for spouses was always a point of contention when we were moving around due to military moves back in the 80s and 90s.

Your military spouse should do whatever is necessary to get domiciled in the correct (read "least taxed") state. A military spouse can now be legally domiciled in the same state as his or her spouse and, of course, that state should be one with the least amount of state income taxes.

Example: Jack, a captain in the Navy (just to show my continued jointness), declared his state of residency to be Florida. He is transferred to San Diego and his wife, Jean, moves with him to California. Unlike previous years, Jean's wages from her job will not be taxable income in California, if Jean properly domiciles in Florida.

What is unchanged is if Jack takes a part-time job in San Diego, his wages are reportable to California and taxable in California.

Live as if you were to die tomorrow.
Learn as if you were to live forever.

Mahatma Gandhi (1869-1948)

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