# How to profit from inflation

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Inflation is defined as a sustained increase in the price of goods and services. In an inflationary environment, a gallon of milk that once cost $3 may now cost $4. Over time, inflation erodes the value of a nation's currency. There are a variety of factors that influence inflation and arguments about its root cause, but for consumers and investors, the end result is the same. Prices rise.

But while rising prices are bad news for consumers, as it takes an ever-increasing amount of money to purchase the same basket of goods and services year after year, inflation can be quite profitable for investors.

The key to making money in an inflationary environment is to hold investments that increase in value at a rate in excess of the rate of inflation.

## Inflation-Sensitive Investments

A number of investments have been historically viewed as hedges against inflation. These include real estate, gold, oil, stocks and inflation-indexed bonds.

### Real Estate

Real estate is a popular choice not only because rising prices increase the resale value of the property over time, but because real estate can also be used to generate rental income. Just as the value of the property rises with inflation, the amount tenants pay in rent can be increased over time, enabling the income generated by an investment property to keep pace with the general rise in prices across the economy.

### Gold

Gold is also a popular inflation hedge. Investors tend to turn to this precious metal during inflationary times, causing its price to rise. While silver and other metals also tend to gain value during inflationary times, gold is generally the headline-grabbing investment, with the price of gold shooting up when inflation is notably present.

## Oil

Like real estate and gold, the price of oil moves with inflation. This cost increase flows through to the price of gasoline and then to the price of every consumer good transported by truck or produced by a machine that is powered by gas (crop pickers, tractors, etc.). Since modern society cannot function without fuel to move vehicles filled with consumers and consumer goods, oil has a strong appeal to investors when inflation is rising. Other commodities such as cotton, orange juice and soybeans also tend to gain in price when inflation rises.

## Stocks

The same logic applies to stocks. Companies can generally pass rising costs on to consumers. Based on this, stocks have a reasonable chance of keeping pace with rising inflation. Some companies have a better opportunity to pass on rising costs than others. Toothpaste and toilet paper, for example, are two items that most people will continue to purchase even when these items cost more at the grocery store.

## Inflation-Indexed Bonds

Inflation often causes interest rates to rise. Because interest rates and bond prices have an inverse relationship, inflation makes existing bond holdings worth less to investors. To overcome this obstacle, investors can purchase bonds that are inflation-indexed.

In the United States, Treasury Inflation Protected Securities are a popular inflation-indexed investment. TIPS, as they are commonly called, are pegged to the Consumer Price Index. When the Index rises, so does the value of an investment in TIPS. Not only does the base value increase but, since the interest paid is based on the base value, the amount of the interest payment rises with the base value increase. Other varieties of inflation-indexed bonds are also available, including those issued by other countries.

## Less Conventional Investments

Arguments can also be made for other investments. For instance, bank loans and high-yield debt are potential inflation hedges. Bank loans are a floating-rate instrument, which means the banks can raise the interest rates so that the return on investment keeps pace with inflation. High-yield debt tends to gain in value when inflation rises, as investors turn to the higher returns offered by this risker-than-average fixed-income investment.

## How to Invest

Inflation-sensitive investments are accessed in a variety of ways. Real estate can be purchased directly by buying a building or accessed indirectly through investment in a real estate investment trust.

Gold can also be purchased directly or indirectly. You can put a box of the metal under your bed if a direct purchase suits your fancy. Or you can invest in the stock of a company involved in the gold mining business. You can also opt to invest in a mutual fund or exchange-traded fund that specializes in gold. Here, you have the option of an actively managed fund that offers the service of a professional money manager or a passive, index-based product.

Oil and other commodities are significantly more difficult to purchase directly and store than gold. Rather than put a barrel of oil in your garage or bushel of soybeans under your bed, it is far more convenient to invest in an exchanged-traded fund that specializes in agricultural commodities or businesses. You may also choose to invest in an exchange-traded partnership that gains exposure to commodities through the use of futures contracts and swaps.

If you are a more sophisticated investor, you can invest in various commodities through the use of futures contracts purchased directly rather than through a pre-packaged investment vehicle. If you choose to walk down this path, be sure you understand what you are buying, as well as the potential for losses and the associated tax consequences.

On the fixed-income side, inflation-indexed bonds are similar to stocks in that they can be accessed in a variety of ways. Direct investment in TIPS, for instance, can be made through the U.S. Treasury or via a brokerage account. They are also held in some mutual funds and exchange-traded funds.

## The Bottom Line

There are pros and cons to every type of investment hedge, just as there are pros and cons with just about every other type of investment. Similarly, there are no guarantees. Traditional inflation hedges don't always work, and unique economic conditions sometimes deliver excellent results to surprising assets while leaving what seemed to be sure winners trailing in the dust. That's why it's called "investing" (which is based on a combination of logic and hope) and not a "paycheck" or "guaranteed way to make money."

Whatever course of action you choose, you are taking a chance. Sometimes that chance will pay off, and other times it won't. In any event, time often heals all wounds. If you can't afford to be wounded or don't have the time to wait for recovery, position your portfolio accordingly to minimize your worries.

If that's not an option for you at this time, carefully consider the various investments designed to protect your portfolio from the ravages of inflation and choose the one that best meets your needs.

Diversification is also worth considering, as there's no need to limit your portfolio to a single investment vehicle. Spreading the risk across a variety of holdings is a time-honored method of portfolio construction that is as applicable to inflation-fighting strategies as it is to asset-growth strategies.