ROBERTS MACKIE WINSTANLEY
INDEPENDENT FINANCIAL ADVISERS

FACTSHEET

Preparing for the risk of inflation

The corrosive impact of rising prices on investments

A pound saved is a pound earned. But thanks to inflation, over time, the value of the pound saved could be much less than when it was earned. One cannot ignore the corrosive impact of rising prices on investments.

Investors can easily fail to prepare for the risk of inflation eroding the purchasing power of money, especially in a low-inflation environment. Therefore, it is wise for portfolios to include assets that help offset the effects of inflation.

MAINTAIN THE PURCHASING POWER OVER TIME

After two years when consumer prices in the UK barely rose, there are signs that inflation may be about to return. If it does, how should you prepare? To help maintain the purchasing power over time, your savings need to grow at least as quickly as prices are rising.

The Bank of England forecasts that consumer price inflation will remain above 2% in each year until 2021. While nowhere close to historic highs, higher inflation stands in contrast to near-record-low interest rates offered on cash savings. Higher inflation represents a hike in the cost of everyday living – and the higher it rises, the less your cash will be ultimately worth. Rising inflation weighs on both real wages and savings returns for UK consumers.

BIGGEST ENEMY OF CASH SAVERS

Keeping enough cash aside to cover any foreseeable costs you might face is always sensible, typically three to six months of your monthly outgoings. However, relying solely or overly on cash might prevent you from achieving your long-term financial goals, which may only be possible if you accept some level of investment risk.

Worse, in an environment where the cost of living is rising faster than the interest rates on cash, there is a danger that your savings will slowly become worth less and less, leaving you worse off down the road.

SEEKING HIGHER INVESTMENTS RETURNS

If you are prepared to take on some investment risk, you could look at investing in a bond fund to look for higher returns. Bond funds invest in a basket of IOUs issued by governments and/or companies looking to raise cash. When someone invests in a bond, they are essentially lending the bond issuer their money for a fixed period of time.

But higher inflation can also be bad news for investors in bonds. Bondholders receive regular income payments, known as 'coupons', from the Government or company that issued the bond. Where coupons are fixed in value for the life of the bond – often several years – the real value of this income will be eroded if prices rise. The nominal value of the bond (known as the 'principal') will also be worth less when it matures and the loan is repaid.

INVESTOR INCOME RISING IN LINE WITH INFLATION

Protection against this threat is offered by inflation-linked bonds, whose coupons and principal will track prices. By linking coupons to prices, the income that investors receive will rise in line with inflation, so they should be left no worse off – unless, of course, the bond issuer fails to keep up with repayments (an unavoidable risk for bond investors).

If prices fall, however, so would the value of inflation-linked bonds and the income from them – in contrast to bonds whose principal and coupons are fixed – and so would then be worth

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more in real terms. If inflation falls, protection from it rising can therefore come at a price.

RELATIVELY STEADY AND PREDICTABLE INCOME

Broadly speaking, bonds are typically viewed as a lower-risk option than shares and generally offer a relatively steady and predictable income, though some bonds do carry higher risk than some shares.

Opting for a bond fund can help you diversify your risk, but these portfolios come in many guises, and some will carry greater investment risk than others. Generally, they will all hold bonds that are at various stages of their life and therefore will vary in value.

EQUITIES DURING INFLATIONARY PERIODS

To beat rising prices, the total returns from any investment – being the combination of capital growth and any income – must be greater than the rate of inflation. As a result, company earnings may have the potential to keep up with inflation, all things being constant, but there can be no guarantee of this – some companies may fail in inflationary times.

However, company shares (or 'equities') offer the potential for long-term investors to offset the effects of inflation. Ultimately, shares are claims to the ownership of real assets, such as land or factories, which should appreciate in value if overall prices increase.

STEADY INCOME STREAM AS WELL AS CAPITAL GROWTH

Equity returns, in theory, should therefore be inflation-neutral, so long as companies can pass on any higher costs they face and maintain their profitability. In turn, a company's ability to make money will typically be reflected in its share price and its ability to provide investors with an income in the form of a dividend.

Opting for a fund which invests in a wide spread of stocks is less risky than putting your money into just a handful of shares. While you could invest in a low-cost tracker fund, which will simply mirror the performance of a particular index (such as the UK's FTSE 100), equity income portfolios – which generally aim to deliver a steady income stream as well as capital growth – tend to be very popular with investors.

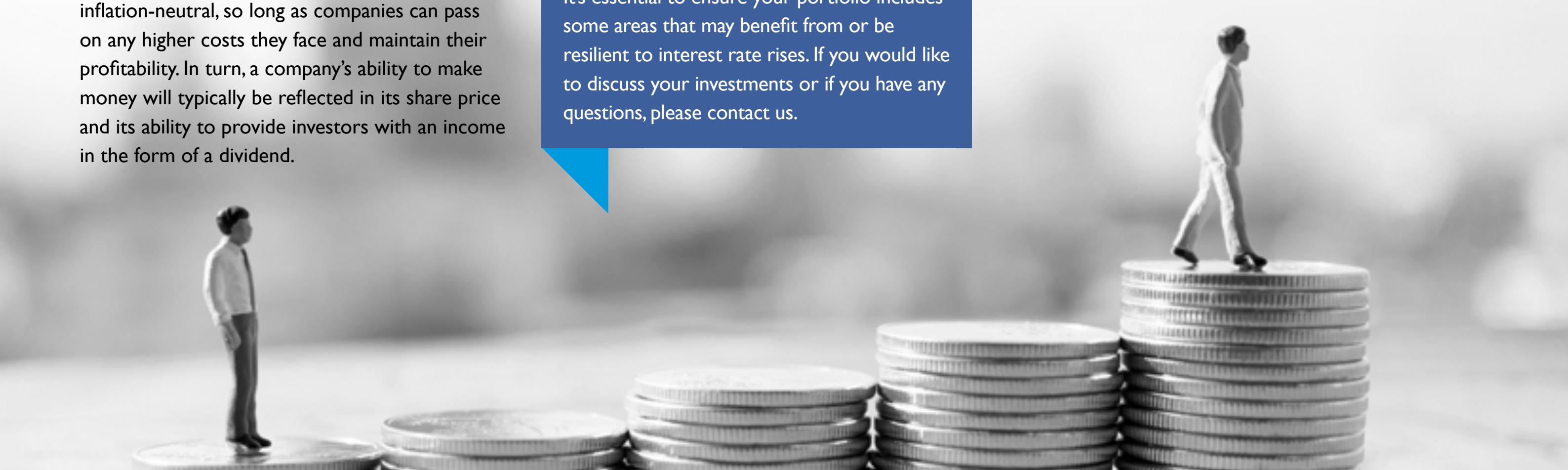
HIGHER INFLATION SQUEEZES PURCHASING POWER

These vehicles invest in the shares of dividend paying firms, or companies that tend to share their profits with their shareholders, and investors can opt to either take the income or instead re-invest it. It is vital to understand that dividends are not guaranteed: they depend on companies' profits, and those companies can decide to cut or cancel their payouts altogether – all of which can also cause share prices to fall.

Where higher inflation squeezes consumers' purchasing power, some companies may find it difficult to pass on higher costs, reducing profitability and, probably, investment returns. Just as a company can raise its dividend in line with inflation, it can choose to cut or stop the payout at any point. ■

STAYING AHEAD OF INFLATION

Inflation has been quiet for a very long time. But there are some signs that inflation may be about to return. If it does, are you prepared? It's essential to ensure your portfolio includes some areas that may benefit from or be resilient to interest rate rises. If you would like to discuss your investments or if you have any questions, please contact us.



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