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Intelligent Money

Louis Kokernak CFP, CFA

Haven Financial Advisors
7000 N. Mo-Pac Expy.
2nd Floor
Austin, TX 78731
voice 512 514 6250
fax 800 888 5480
louis@havenfinancial.com

Special Notes of Interest:

- Since 1972, tuition and fees at a 4 year public institution of higher learning have increased at a rate of 12.0% annually
- Since 1926, inflation has averaged 3.1% annually . The 5-year treasury note yielded only 2.24% on June 4th.

Current thinking from Haven Financial Advisors

Hedges against Inflation

As investors age, their perceptions of risk change. Their ability to work more or consume less decreases as time goes on. Job and savings options diminish and aversion to risk increases. Conventional financial planning dictates that clients therefore reduce the volatility of their investments as they approach retirement. The focus turns to inflation as a key risk. Corporate pensions are usually not indexed for inflation. In today's adverse profit climate, the ad hoc pension increases of the past can scarcely be relied on.

Other investors might exhibit keen sensitivity to price inflation. Parents saving for their child's college education recognize that tuition and fees have increased faster than the more general consumer price index (CPI). Funding a college education is a material expense for the vast majority of families and a significant inflation risk.

What, then, is a hedge against inflation? Good candidates should reliably provide excess returns to the CPI. Stocks, for example, offer the highest long-term premium to the CPI but may underperform for critical periods. Since 1926, the S&P 500 has outperformed the CPI by 6.9% annually. On the other hand, the S&P 500 lagged the CPI from January 1998 through yearend 2002. Over short time horizons, stocks are an unreliable hedge against inflation.

Traditional fixed income products like T-bills and commercial paper have usually outperformed inflation. Over the past 18 months there has been a precipitous decline in interest rates. Commercial paper rates struggle to surpass 1.20% Even the 2-year treasury note yields only 1.18%. Money market yields today are unlikely to maintain buying power under a moderate inflation scenario.

There are two products of recent vintage that promise reliable returns in excess of consumer inflation. They are Treasury Inflation-Protected Securities (TIPs) and Series I Savings Bonds or I Bonds. The former were first issued in January 1997 and the latter in September 1998. They both pay a fixed interest rate with a principal amount that is adjusted for the CPI. This fixed interest rate is known as the *real yield* or return in excess of inflation. Since the principal increases with a well-recognized price index, the overall return on investment is highly correlated with inflation. That makes for a good hedge.

TIPs trade on the secondary market just like other treasury securities. When issued, they pay a fixed coupon on a principal amount that is adjusted for inflation. Their real yield changes thereafter with market conditions, however. TIPs prices move away from par value. The TIPs maturing 07/15/2012 actually traded at 111% of par value on June 3rd. Real yields initially offered by TIPs have fallen as they have been compressed by the overall decline in interest rates.

The fixed rate for I-bonds is set twice annually. Determined at inception, this fixed rate prevails throughout the 30 year life of the bond. On May 1st, the Treasury guaranteed that I bonds issued over the next six months would earn a return of 1.0% in excess of inflation. In the long run, a 1.0% premium to inflation is lower than that offered by stocks ... but is much more

Inflation Hedges (continued)

reliable. Moreover, it is higher than that implied by the market prices of short and medium term TIPs. I bonds are intended as a consumer product as each investor is limited to $30,000 in purchases annually. The investor may defer paying taxes on interest income for up to 30 years. Taxes may be excused if income is used for qualified education expenses.

With inflation this tame, why bother hedging against it? A deciding factor may be the investment horizon of the assets in question. It may not make sense for a 25 year old to explicitly hedge against inflation in an IRA. However, an endowment that covers the operating costs of several charities with its income might be well served with a product that hedges against unexpected price changes. The same can be said for a couple that is saving for home remodeling within the next 18 months. An investment in TIPs should never underperform inflation.

A second reason may be that price risk has been downplayed with recent Fed warnings about deflation. Despite the business press fascination with the prospects of a deflationary spiral, oil and gas prices remain volatile. A recent survey of professional forecasters compiled by the Fed revealed that inflation projections have increased to 2.3% over the next year.

The takeaway from the foregoing analysis is that nominal interest rates are so low that they cannot reliably protect purchasing power over the next year or so. Securities that explicitly adjust for inflation are likely to offer superior returns if price inflation approaches its recent performance. The table below illustrates.

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1 year Treasury Bill	***90 day Commecial Paper***	***Trailing 5-year Average Inflation***	***Consensus Forecast of Next Year's Inflation***	***Real Yield of the 1 year TIPs***	***Real Yield of the I-bond***
1.04%	1.19%	2.54%	2.30%	0.18%	1.00%

If inflation forecasts are realized, these inflation hedges will substantially outperform conventional short term securities listed at the left -> I bond return will be 2.30%+1.00% = 3.30%

Hedging against the Cost of a College Education

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College costs have increased notoriously faster than the CPI. Over the past 30 years, the College Board has measured increases in college tuition and fees that are in excess of 8% annually. Fortunately, Texans have an investment option available to them to offset this risk. The Texas Guaranteed Tuition Plan (TGTP) allows its participants to pay for a fixed number of credit hours in a public or private Texas educational institution. Each year the dollar value of a credit hour is adjusted upward for the increased cost of a higher education.

There are several payment options. Parents can purchase up to 160 credit hours in advance for a typical private or public institution. These credit hours are redeemable in cash if the child attends college out-of-state. The program will cut a check to the institution at the then-prevailing cost of a credit hour of tuition. The benefits grow at a rate that is closely tied to college inflation. Moreover, distributions are not taxable along as monies are spent on qualified educational expenses