

The “Real” Impact of Inflation!!!!

“Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair.” Sam Ewing

Indeed the above quote could not be clearer about the “real” effects of Inflation. It is an illusion of wealth, a tax without legislation and an adversary for most. Unfortunately, it is something that we have to live with and facing up to the facts will only help us to deal with it better.

Just a couple weeks ago we saw where National Flour Mills Limited increased the price of flour by almost 15 per cent. This led to the spiraling effect of other industries passing off increased input costs to the consumer...from our local roti shops to the foreign burger joints took a hit! We also saw reports where the price of cheese skyrocketed 100 per cent between January and November and that there were signs of further increases between 25 and 40 per cent for the next three months. These are just two examples but in reality the effects of Inflation are widespread and infectious.

By definition, Inflation is the rate at which the general level of prices for goods and services is rising which subsequently leads to a fall in purchasing power. Ironically, this situation usually stems when there is “too much money chasing too few goods.” The Inflation Rate is usually measured by percentage changes in the cost of a basket of consumer goods and services. In Trinidad and Tobago, the Retail Prices Index is the indicator used to measure Inflation. While the above definition captures the main picture, it is very common to look at Inflation very narrowly, but as investors it is critical that we look deeper than rising prices.

We all like to hear an investment story with a happy ending and it would seem that no one likes to share the ones with gloomy endings! However what some of us fail to realize is some returns are not as high as they might seem. For instance, let's say you invested in the local stock market in 1992, using the Index as a measure of return – you would have made a whopping nominal annualized rate of return of over 1,500 per cent by the end of 2006. However, if we add Inflation into our formula, the real rate of annualized return would boil down to just below 20 per cent. While the impact from the above example may seem enormous it does not mean that we should be despondent. Inflation can be beaten!

Inevitably Inflation will have an impact on your portfolio, but the severity of the impact would depend on your security mix or asset allocation. Generally, equity is seen as a better hedge against inflation than fixed-income investments. This is because in the long term a company can increase its prices at the same pace as inflation. Increased prices will usually result in increased revenue and earnings. The exception to this rule being stagflation, which is a situation of Inflation, coupled slow economic growth, but that is an entirely different article. Also, it is important to note that in times of Inflation the sustainability of a company's profits can be overestimated since costs may be calculated using historic prices and not current costs.

On the other side of the coin, Fixed Income Investors are the hardest hit by inflation. This is because fixed income investments as the name implies, is set at the beginning of the investment and so the real rate of return is only calculated when the inflation rate is subtracted from the nominal rate agreed upon at the beginning of

the investment. So let's say you invested \$1 million in a bond with a 10 per cent yield, then at the end of the year you should receive \$1.1 million, but is the \$100,000 your real return? Can you purchase the same basket of goods with that \$100,000 that you would have been able to purchase at the beginning of the investment? Well, if the Inflation Rate was 7 per cent, then that means that your real rate of return was only 3 per cent or \$30,000. To put another way, your money grew by 10 per cent in nominal terms but your purchasing power fell by 7 per cent in real terms! So what would have cost you \$30,000 at the beginning of the investment period now costs \$100,000.

Suffice to say, investors should always try to invest in a mix of products that are either equal to or greater than Inflation. Even the most conservative investor should maintain a reasonable level of equity in his portfolio to protect against the erosive effects of Inflation. Of course, the more aggressive your portfolio the greater the "real" returns in the long term. Of course depending on your investment objectives, time horizon and risk tolerance, it may not always be easy to meet or beat Inflation. For instance, if you are in Retirement and living off of your pension, it would be very risky to try and hedge against Inflation by investing the money that you need to survive in equity, assuming of course that you don't have any other supplemental income.

At the end of the day, Inflation will always be around; while some years will be better than others it certainly has an impact on all of us. As investors we need to be aware of it and ensure that our portfolios are designed to meet our objectives in real terms. After all, it's not how much more money you end up with but how much more you can buy!

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