Keep Inflation in Mind When Investing

As an investor, you're no doubt aware of the potential effects of market volatility on your portfolio. But you also need to pay attention to another factor that could impact your investments' return: inflation.

If you look back over the last few decades, you might not think inflation is much of a threat. Since the double-digit rates of the early 1980s, inflation has fallen significantly and, for the most part, has stayed low. Still, over time even a mild annual inflation rate can eventually erode your purchasing power.

Obviously, if you are a retiree or close to retiring, you need to plan for the impact of inflation on your income stream, which may, to a large degree, depend on the types of investments you own. But even if you're at an earlier stage in life, you need to think about inflation because it can reduce the "real" rate of return you receive on your investments.

However, you can find investments that may be able to help you cope with inflation. With stocks, for example, you can have an ownership stake in companies that have the ability to raise prices — which makes them effective inflation-fighting investments. Keep in mind, though, that stock prices will fluctuate, and there's no guarantee you won't lose some, or all, of your principal.

One of the biggest inflation-fighting benefits of stocks is the *dividends* they may pay. Well-run companies may reward investors by paying them dividends — and some companies have increased their dividends annually for decades. A word of caution, though: Companies can reduce or eliminate dividends at any time without notice. In fact, during the long market slump we experienced, some companies did cut back on their dividend payments.

Not all stocks pay dividends, of course. But in any case, if you're going to maintain a balanced portfolio, you'll also want to own other types of investments, such as bonds. But many bonds — along with other fixed-income vehicles, such as certificates of deposit (CDs) — are not good "inflation fighters" because the fixed rate of return they offer simply may not keep up with inflation. Consequently, you may want to explore a "laddering" strategy. When you build a bond ladder — that is, when you purchase a group of bonds with varying maturities — you'd have more flexibility in combating inflation, because your longer-term bonds typically offer higher interest rates.

What about the so-called "inflation hedges," such as commodities and real estate? Actually, these hedges are extremely volatile and should be approached with great caution. You need look no further back than the bursting of the housing bubble to see that real estate can go down just as fast as it goes up — and once down, it can take years to recover.

In your efforts to invest wisely for the future, inflation is only one variable you need to consider. But it can be an important one — so make sure you choose the investments that both address inflation and can help you make progress toward your financial goals.

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