Investing with a View of Significant Inflation

By Bob Kargenian
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What do we plan to do with client portfolios in the event of very high inflation? This question, which has been posed by our clients, is timely. Almost all the analysis we read has concluded that, with the Fed seemingly printing money out of nowhere, the inevitable consequence *must* be significantly higher inflation.

We're not convinced, but we have identified which strategies are likely to best protect clients if inflation accelerates.

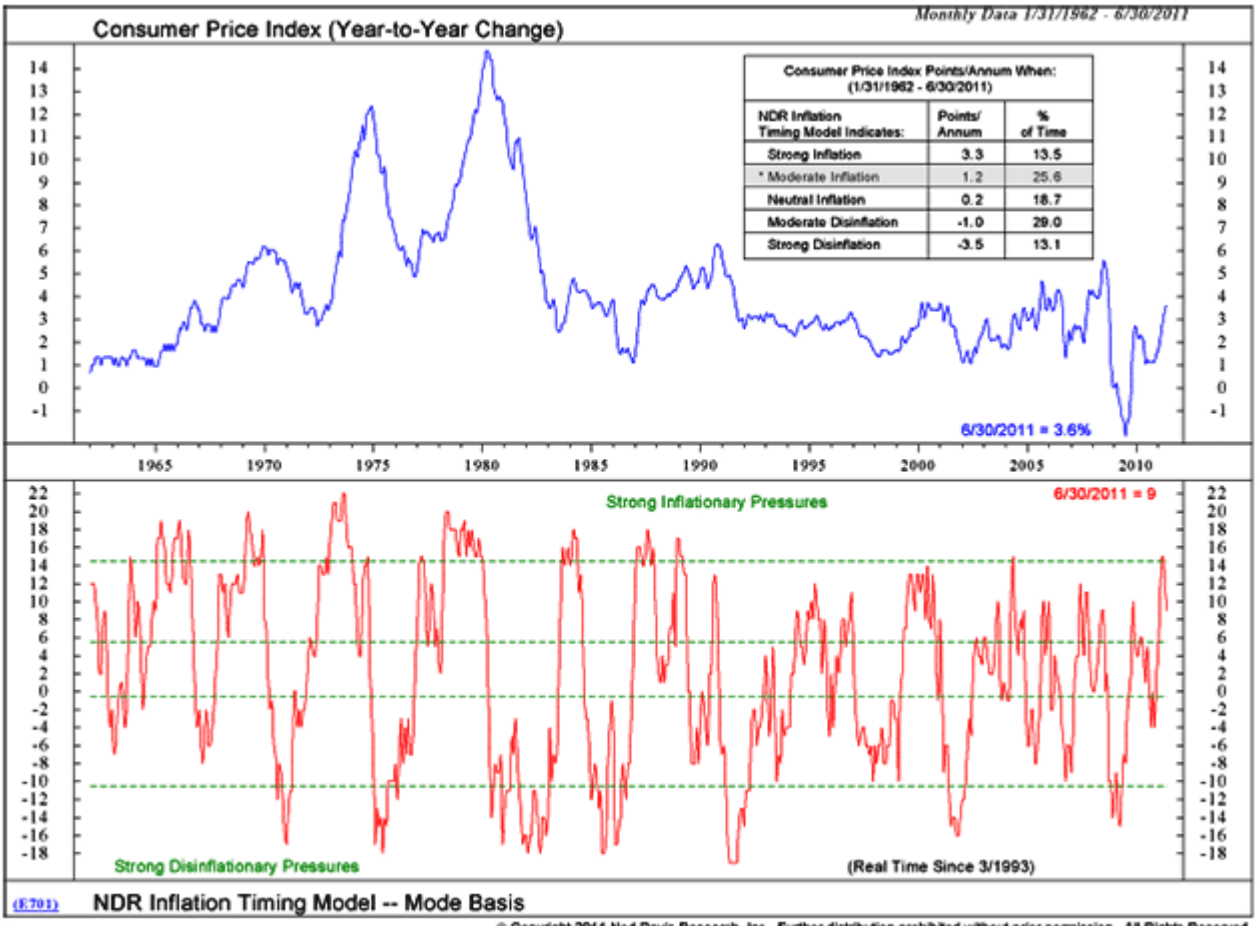
At the moment, inflationary pressures are advancing, with the year-over-year increase in the CPI running at 3% and rising. The chart below, which illustrates the Inflation Timing Model from Ned Davis Research, also shows high inflationary pressures.

Thus far, however, inflation has not manifested itself into higher interest rates. Quite the contrary. Since February 9 of this year, the yield on the 10-year Treasury note has dropped from 3.74% to under 3%. Some of this drop may be attributed to QE2, but more recently, several economic reports have shown concern about a weakening economy, which would be deflationary, not inflationary.

Let's look at how various investment strategies have fared under inflation and its byproduct, high interest rates.

The historical record on investing during inflationary periods

My research shows there have been only two periods in modern financial market history (since 1926) in the United States that have had significant bouts of inflation: from 1941 to 1947, in the aftermath of World War II, and from 1973 to 1981. The latter period will probably resonate more with readers, because even those who may be 64 or older today are not likely to remember the 1940s.



The CPI grew at a 7.5% compound rate from 1941 to 1947 and jumped by over 18% in 1946. To protect ourselves from rising inflation, one should learn how various investment strategies performed during similar periods. Unfortunately, we only have data for the stock market and government bonds, and interest rates were capped by the government at 2.5% during those years. There are no data on the price of gold, or gold mining stocks, to my knowledge. Real estate investment trusts, inflation-protected securities and high-yield bond funds weren't around back then.

But we do know that during that period, large-company stocks — as represented by the S&P 500 — compounded at an 11.4% return during those seven years, *well in excess of inflation*. Data from Ibbotson Associates show that small-company stocks, as represented by the smallest 20% of companies on the New York Stock Exchange, did much better. The annual returns from small companies from 1942 to 1945 were 44.5%, 88.3%, 53.7% and 73.6%.

Unfortunately, there were no publicly traded mutual funds at that time that invested strictly in small companies and could verify this data. Using John Hussman's formula for

projecting returns on the S&P 500, valuations in 1941 were very good for stocks, with expected returns going out 10 years at about 16% compounded. In other words, stocks were cheap.

In contrast, the return from intermediate-government bonds during the seven-year period was less than 2% compounded, with the lowest annual return at 0.50% and the highest at 2.81%. So, though passively investing in bonds did not result in a loss of capital, it did result in a pretty significant lag relative to the rate of inflation. As you'll see in the table below, this was also the case for most bond investments from 1973 to 1981:

	CPI	10-year Tnote Yield	SpotGold	BGMI	INIVX	LgStocks	SmStocks	BFundAm	PINCX	FrUSGov	FrHiIncome
1973	8.8	6.74%			91.99	-14.66	-30.9	n/a	-2.4	0.61	-22.37
1974	12.2	7.43%	174	400.9	10.87	-26.47	-19.95	3.73**	-7.47	1.93	-17.05
1975	7.01	8.00%	140	347.15	-23.65	37.2	52.82	12.68	17.2	6.58	13.24
1976	4.81	6.87%	134	282	-28.48	23.84	57.38	18.11	20.62	13.02	37.73
1977	6.77	7.69%	165	290	32.84	-7.18	25.38	5.14	5.49	1.79	10.28
1978	9.03	9.01%	226	326	9.69	6.56	23.46	2.03	1.62	-1.38	-2.7
1979	13.31	10.39%	512	546	176.48	18.44	43.46	3.14	-1.89	1.5	4.78
1980	12.4	12.84%	601	998	64.52	32.42	39.88	3.54	-0.15	-12.86	2.06
1981	8.94	13.72%	401	624	-19.87	-4.91	13.88	6.64	8.03	7.06	6.84
Compound Return	9.2		12.7	6.5	22.4	5.2	18.8	7.2	4.2	1.8	2.3

Legend	CPI	=	Consumer Price Index
	Spot Gold	=	Handy & Harman Price with data beginning January 1975
	BGMI	=	Barron's Gold Mining Index with data beginning January 1975
	INIVX	=	Van Eck International Investors Fund
	Lg Stocks	=	S&P 500 Index
	SmStocks	=	As defined in the Ibbotson SBBI 2008 Classic Yearbook
	BFundAm	=	Bond Fund of America
	PINCX	=	Putnam Income Fund
	FrUSGov	=	Franklin U.S. Government Income Fund
	FrHiIncom	=	Franklin High Income Fund
	**	inception of Bond Fund of America was May 28, 1974	
Note		The compound return numbers for Spot Gold and the BGMI were for 7 years and for 7.5 years for Bond Fund of America, and were for 9 years for all other items.	

During the 1973-1981 period, as shown above, the CPI compounded at 9.2% annually. In contrast to the 1940s (when rates were capped), interest rates rose rapidly, with the yield on the 10-year Treasury note advancing from 6.7% to eventually over 14%. Gold, which had a fixed price until the early 1970s, rose from $174 to over $800, before falling 50% from its peak. Yet, spot gold compounded at 12.7% in the comparable time frame.

Gold as an inflation hedge

In the limited data available on gold-mining stocks, there were two contrasting results. The Barron's Gold Mining Index (BMGI) has data starting in January 1975, so we are missing two important years, but it shows that gold-mining stocks compounded at 6.5% from January 1975 to December 1981 and lost over 37% the final year after the peak in gold prices. However, the Van Eck International Investors Fund, which primarily invests in gold stocks and has been around since 1956, was a home run during the period, growing at

over 22% annually, despite three calendar years with losses of 20% or greater, including a 45% loss in 1975-76.

This suggests that gold stocks should be a point of emphasis during a period of high inflation. But without a strict risk management plan, one cannot make a passive allocation to gold, because it would become a situation of behavior management. Let's say one has a 10% portfolio allocation to gold stocks. How many investors would sit through losing 45% of their capital?

Gold stocks are nearly 2.5 times more volatile than the average stock. Clients want more of *anything* when it is going up substantially. The problem is, they rarely have a plan of for when to get out. Most people cannot deal with the downside volatility that is inherent in investing in the stock market and it worsens with precious metals stocks. Therefore, in my view, the risk must be managed.

Stock market performance during the 1973-1981 inflation

Looking at the performance of stocks during the 1973-1981period, we see that large stocks compounded at 5.2%, but small stocks soared, growing at over 18%. And this was after starting the period with substantial losses during the 1973-74 bear market, when the S&P 500 fell by 37% cumulatively over those two years. The results were also close to projected returns from Hussman's formula noted above — future 10-year returns on large stocks were in the 6% range at the end of 1972. Small company valuations were even more favorable, and thus they performed better.

I was able to find past returns for four bond funds that were in existence for most or all of the period. The best return was from the Bond Fund of America, with a 7.2% compound gain over 7.5 years. The worst was the Franklin U.S. Government Fund at 1.8%, followed by Franklin High Income (high yield bonds) at 2.3% and the Putnam Income Fund at 4.2%. This was during a time when interest rates doubled from 7% to 14%. All the funds made money, but they were mostly way behind the 9.2% growth rate of the CPI.

Stocks, bonds or gold – which is best?

We only have had two occasions of high inflation, and the smallness of the sample set is hardly reassuring for those of us who rely on probabilities. Large stocks outperformed in the 1940s but lagged in the 1970s, while small stocks outperformed in both periods. Gold and gold stocks outperformed in the 1970s but weren't investable in the 1940s. Passive investments in bonds lagged significantly in both periods.

Stock valuations were very different at the beginning of each period. Today, future 10-year returns (using Hussman's formula) are pegged at around 4% for large stocks, so they are comparatively more expensive than at the end of 1972. Even if inflation averaged 7%

again for 10 years, stocks are still likely to earn positive returns, but those returns would likely lag inflation as they did in the 1970s.

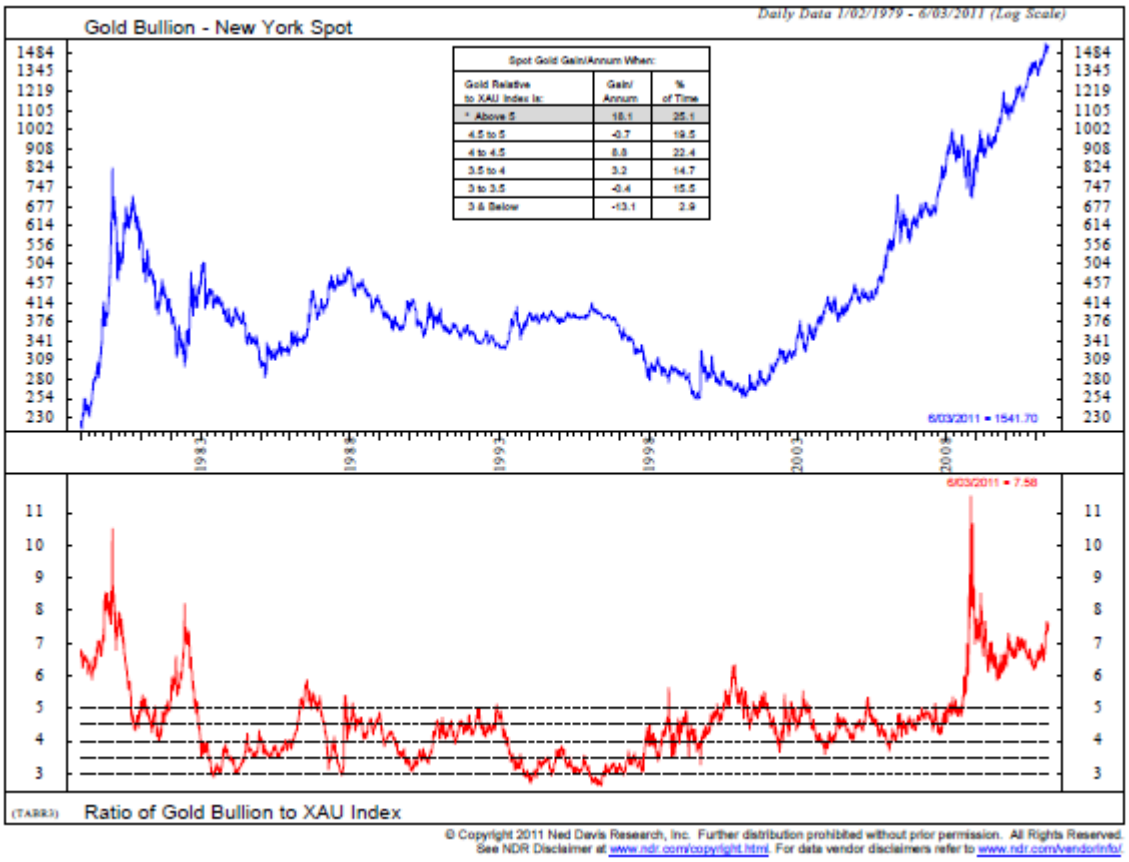
The limited data we have indicate that bonds are the most vulnerable to poor relative returns. But the data show passive returns. Because it is unlikely that interest rates will go straight up, investment strategies that have the flexibility to vary exposure and duration over time can generate higher returns.

For example, during the 1973-74 bear market, the Franklin High Income Fund, which invested primarily in high-yield corporate bonds, lost more than 22% in 1973 and another 17% in 1974. The only worse calendar year for high-yield bonds was 2008, when the average junk bond fund fell nearly 25%. A robust risk management model, which is beyond the scope of this article, should be able to minimize losses in such unfavorable environments.

Even in the safest of asset classes, GNMAs, yields could rise from the 3% zone to over 7%. Passive investors would not fare well in that environment, but a tactical approach could preserve capital.

Finally, let's revisit the area of gold and gold stocks. Gold stocks performed very well in the 1970s, and though they have lagged the performance of physical gold since 2000, they've performed quite well since then. Today, the ratio of physical gold to the XAU Gold Index (which tracks gold-mining companies), as shown on the charts below courtesy of Ned Davis Research, is over 7.3-to-1. Since 1979, this ratio has been greater than 5-to-1 25.4% of the time, and during those times physical gold has compounded at over 18% annually.

Spot Gold Gain/Annum When:		
Gold Relative to XAU Index is:	Gain/ Annum	% of Time
* Above 5	18.3	25.4
4.5 to 5	-0.7	19.4
4 to 4.5	8.8	22.3
3.5 to 4	3.2	14.6
3 to 3.5	-0.4	15.5
3 & Below	-13.1	2.9



Bottom line: Gold stocks are cheap relative to gold, and they are likely to be helpful contributors to keeping ahead of inflation, provided one can get the timing and risk management mostly right. Though physical gold has performed well under the current conditions, gold-mining stocks offer better valuations.

A long-term BUY signal for gold stocks took place June 24, 2011, for only the 14th time since 1976. This signal is based on our version of a variation of the Gold/XAU Ratio, known as the K-Ratio (named after researcher Jay Kaeppel), which uses the Barron's Gold Mining Index. Relative to physical gold, as represented by the ratio, gold stocks are at the second-cheapest level in nearly 35 years. Gold stocks have gained nearly 12% since June 27, as of July 14. The results of past signals are shown below.

			Percentage Gain/Loss			
Date	**Ratio**	**Barron's GMI**	**3 months**	**6 months**	**9 months**	**1 year**
9/3/1976	1.94	208.82	40.20%	45.30%	24%	**42%**
3/3/1978	1.61	295.24	1.56	24.8	1.57	**20.67**
1/12/1979	1.48	323.31	3.68	16.13	31.49	**87.5**
10/26/1979	1.08	404.59	66.2	49.2	111.1	**185.3**

9/20/1985	1.68	537.41	-6.73	0.36	-14.5	**1.79**
7/25/1986	1.19	416.96	20.5	36.7	131.5	**115.09**
4/24/1992	1.73	583.51	3.52	-10.75	-17.6	**9.54**
11/3/1995	1.74	665.51	35.4	25.54	8.04	**-1.44**
12/26/1997	1.34	390.76	6.66	-8.32	-1.75	**-12.22**
5/7/2004	1.4	531.61	3.18	27.02	15.84	**10.55**
5/6/2005	1.38	587.73	13	31.56	77.69	**96.08**
11/14/2008	0.75	562.92	45.8	61.01	85.6	**120.04**
5/28/2010	0.98	1184.33	2.31	28.41	25.02	**23.4**
6/27/2010	0.91	1385.17				

All of my analysis *assumes* we are going to have higher inflation and rising interest rates. We don't assume anything, nor do we forecast. At present, we see both inflationary and deflationary forces. Prices are rising for food, energy and healthcare, while interest rates are falling, the economy is slowing and housing in particular is distressed. This is stagflation — inflation with slow economic growth and relative high unemployment — such as took place in the 1970s.

And just because assets behaved a certain way in the past under certain conditions, it does not guarantee they'll perform that way in the future. That is why we base our decisions on prices. The best way to get in trouble with investing is to have a pre-conceived notion of what is going to happen and then ignore the evidence. For all we know, we may be in for falling interest rates, a slow economy and rising inflation.

From our vantage point, stocks and bonds are not cheap on an absolute basis and offer little in the way of expected returns and compelling value. At present, the best risk and reward of any asset class is with precious metals shares. Winning by treading water may be the order of the day — or decade.

Bob Kargenian is president of TABR Capital Management, a California-based fee-only Registered Investment Advisor.