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Tipping Point

As inflation threatens the economy, entrepreneurs look to protect their investments.

By Farnoosh Torabi | [Entrepreneur Magazine - February 2008](#)

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Rising gas and food prices aside, John Gaines says he's getting bitten by the inflation bug as a consumer *and* a business owner. As president and co-owner of [Subminiature Instruments](#), a million-dollar manufacturing company in Ogden, Utah, Gaines says he pays almost twice as much for steel, electrical wire and copper as he did a year and a half ago. "We saw a spike in many of our products," says Gaines, 31, who believes inflation may become a bigger economic threat and drag on his family's investment portfolio--63 percent stocks and 37 percent bonds. "[Prices] have been pretty flat over the past seven years, so I expect [inflation will] hit sometime." He says his risk tolerance has dropped considerably over the past few years since getting married and having a baby.

As a hedge, Gaines recently added Treasury Inflation-Protected Securities, or TIPS, to his and his wife's retirement accounts. A relatively new bond instrument, the overall underlying principal, or par value, on TIPS follows the rate of inflation as tracked by the Consumer Price Index for All Urban Consumers and is adjusted daily. Meanwhile, the coupon is constant, stems from the inflated principal and is paid at maturity. Gaines' financial advisor, Paul Winter of Five Seasons Financial Planning, says many investors are still unfamiliar with TIPS--partly because they've only been around for about 10 years in the U.S., and also because investors typically underestimate the risk of inflation.

Year-to-date TIPS are the best performers in the fixed-income category, where the average fund is up about 5 percent, according to Morningstar. "We had a deflationary environment for 20 years," says Winter. "But now that oil [and other prices] have increased, inflation is a creeping danger to the purchasing power of one's retirement nest egg."

A Win-Win Scenario

Experts say investors are rarely in a position to lose with TIPS because the government guarantees the original investment regardless of where the inflation rate travels, even in a deflationary market. And the interest never goes below zero. "By holding them, you're not really losing ground," says Dan Shackelford, portfolio manager at T. Rowe Price. "They're like an insurance premium against higher inflation."

That said, TIPS should be used as a diversification tool. "I wouldn't sell my exposure to the stock market to TIPS," adds Ken Volpert, senior portfolio manager at Vanguard.

The U.S. Treasury Department sells TIPS directly to investors in five-, 10- and 20-year maturities, which avoids broker transaction costs. And individual bonds may be more helpful in one's financial planning because they have maturity dates, says Stan Richelson, co-author of *Bonds: The Unbeaten Path to Secure Investment Growth*. "If my child is going to college in five years, I'd like a five-year fund to help pay for his tuition." On the flip side, there are major tax bites for holding TIPS in a taxable account. Investors must pay income tax annually on the interest payments in addition to the inflation adjustment.

Bundling TIPS

For investors with a longer investment time horizon, buying TIPS through a mutual fund and in a tax-sheltered account eliminates the maturity factor and offers tax incentives. Two more widely purchased funds that invest in TIPS are the Vanguard Inflation-Protected Securities (VIPSX) and PIMCO's Real Return (PARRX), in which Gaines invests. Others include the Inflation-Protected Bond Fund from T. Rowe Price (PRIPX) and the Fidelity Inflation-Protected Bond (FINPX). As with any financial instrument purchased through a third party, there may be expenses related to buying TIPS this way.

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