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Inflation-proof investing Commentary: A portfolio to protect your returns

By Dr. Marvin Appel
Last update: 12:01 a.m. EDT May 1, 2008

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GREAT NECK, N.Y. (MarketWatch) -- Inflation has climbed to 4% this year -- a level not seen on a sustained basis in 17 years -- while the U.S. dollar hovers at record lows.

At the same time, the U.S. stock market remains in a correction, more than 10% below its level from October 2007

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International stock markets have not fared much better in the past two quarters. The yields on Treasury and other federal debt and on bank CDs, are lower than the inflation rate.

As a result of all these developments, investors should be concerned about whether their savings will be able to keep up with rising prices over the long term.

You could hold Treasury Inflation-Protected Securities (TIPS) or Series I Savings Bonds, which are guaranteed to stay ahead of inflation (before taxes). However, the prospective returns from these inflation-indexed bonds are now too low to generate the kinds of returns that most individuals would need to meet their financial needs.

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"The table to the right shows the year-by-year..."
The table to the right is missing in action, oh well. Also, not sure why the author thinks its unfortunate that this portfolio was able to keep up with equities in the 90s? I suppose...
- nord

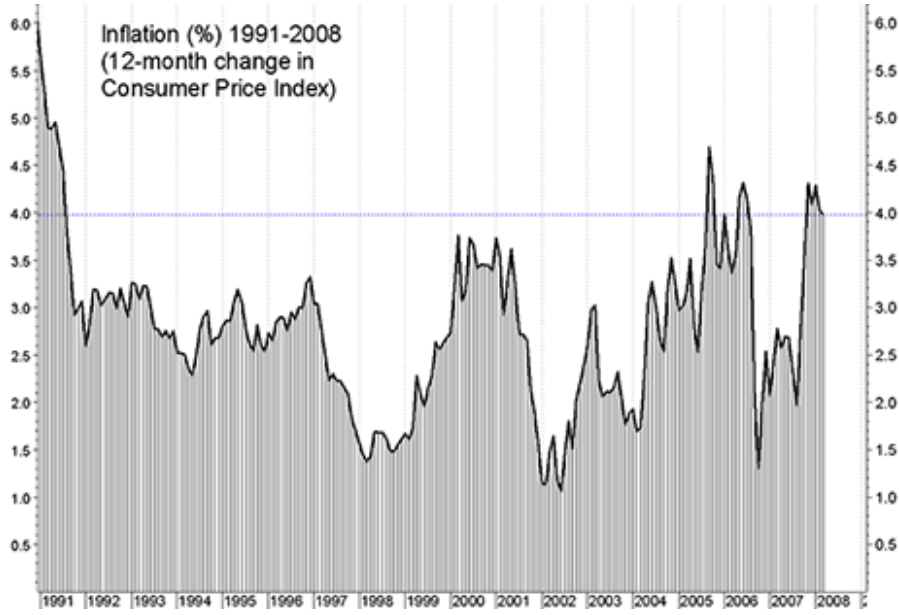
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Rising commodity prices are now driving inflation and have been very profitable in their own right in recent years, as have stocks in companies that produce commodities. However, a limitation of such investments is their high volatility. Here I describe a portfolio that has captured the benefits of the ongoing commodity boom but which has been significantly less risky than either direct investments in commodities or than the U.S. stock market.

The premise is that broad-based investments in countries whose economies depend strongly on commodity production can give you favorable exposure when commodity prices are strong, and a high degree of diversification to limit your risk when inflation pressures are weak. The stock markets in stable, developed countries such as Canada and Australia follow big trends in commodity prices, but can dilute the volatility of a pure commodity-based strategy.

This inflation-proof portfolio has the added advantage of non-correlation with the S&P 500 Index (**\$SPX: 1,393.25, -25.01, -1.8%**). Non-correlation means that adding this mix of investments to U.S. equity holdings might improve not only your returns, but also the level of safety if past patterns repeat themselves.

The inflation-proof portfolio -- equal dollar amounts in each of the following eight investments.

Gold bullion ETFs (**GLD: 85.69, -0.94, -1.1%**) (**IAU: 85.67, -1.07, -1.2%**).

Broad-based commodity index ETFs (**DJP: 65.34, +0.34, +0.5%**).

Agricultural commodity index ETFs (**JJA: 59.32, +0.32, +0.5%**).

Canada ETF (**EWC: 33.46, -0.29, -0.9%**). The Canadian stock market represents commodity producers to a large extent.

Pacific ex-Japan ETF (**EPP: 146.27, -5.52, -3.6%**). The countries most heavily represented are Australia and New Zealand, also big commodity producers.

Permanent Portfolio Fund (**PRPFX: 37.80, +0.20, +0.5%**). This mutual fund has an inflation-oriented portfolio that includes gold bullion and Swiss Francs. Its volatility has been quite low.

First Eagle Global (**SGENX: 45.94, +0.14, +0.3%**).

First Eagle Overseas (**SGOVX: 23.70, +0.06, +0.3%**).

Historical results

The table below shows the year-by-year and overall compounded annual gain and drawdown for the inflation-proof portfolio and the S&P 500 Index. Since the ETFs listed as part of the portfolio are relatively new, I used the performance of the underlying benchmarks (gold bullion, Dow Jones AIG Commodity Indexes, MSCI Indexes) in their places to calculate the hypothetical past results.

There are three striking features in the data. First, the portfolio has

	Portfolio	S&P 500
1993	22.7%	10.1%
1994	0.6%	1.3%
1995	12.9%	37.6%
1996	10.9%	23.0%
1997	-3.1%	33.4%
1998	-7.5%	28.6%
1999	16.7%	21.0%
2000	2.7%	-9.1%
2001	-6.5%	-11.9%
2002	10.4%	-22.1%
2003	31.9%	28.7%
2004	12.6%	10.9%
2005	15.2%	4.9%
2006	16.7%	15.8%
2007	20.2%	5.5%
2008*	0.5%	-9.4%
Annual gain	9.30%	9.50%
Drawdown	-22%	-45%

* To 3/31

beaten the S&P 500 every year since 2000.

Second, the worst drawdown over the past fifteen years for the portfolio has been only half that of the S&P 500. Indeed, the portfolio as a whole has also been far safer than six of its eight individual components. (The worst drawdowns in Canada, the MSCI Pacific-ex-Japan Index and in commodity price indexes have ranged from 37% to 63% since 1993.)

Third, unfortunately, is that the inflation-proof portfolio did keep up with stocks in the 1990s, when the stock market was very strong and the world experienced disinflation.

Implications

Many investors are jumping into commodities in order to cash in on the boom or to protect their purchasing power. However, in doing so they may be assuming an unreasonable degree of investment risk. The portfolio presented here should continue to thrive for as long as current economic trends remain in place, but has been far safer than an investment directly in commodities or in the overall U.S. stock market.

Dr. Marvin Appel is editor of the "Systems and Forecasts" investment newsletter and CEO of Appel Asset Management Corp. www.appelasset.com ■

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