THE 9-LETTER DIRTY WORD

Indicators have shown a spike in inflation in early 2014. Learn how to protect yourself against the inevitable rise of interest rates with these four helpful strategies.

by SCOTT DOUGAN

The word inflation is considered a dirty word to most people. What does it mean for the majority? Rising prices and an income that won't stretch as far as it used to. And while some will benefit from a rise in inflation, most Kansas City residents would be adversely affected if inflation starts to spike.

First, a quick definition: Inflation is the rate at which the general level of price for goods and services is rising and, subsequently, purchasing power is falling. As inflation rises, every dollar will buy a smaller percentage of a good. Simply put, a dollar will buy less.

There are several indicators from the first six months of 2014 that inflation is on the rise. The Consumer Price Index (CPI) is showing some of the largest increases in the price of goods in years. The food, energy, shelter, airline fares, medical care, apparel and new vehicle indexes all increased during the first half of 2014, according to the U.S. Bureau of Labor Statistics.

Currently, our inflation rates have remained low since the "Great Recession" and have averaged between 1 to 3 percent per year since 2008. Why? Because interest rates and inflation are linked. In general, as interest rates are lowered, more people are able to borrow money resulting in more consumer dollars to spend. This causes the economy to grow faster and inflation to increase.

The Federal Reserve is keeping interest rates at historically low rates in an effort to boost the economy. However, there are changes to the interest rate on the horizon. Recently, the Federal Open Market Committee announced that, due to growing economic strength, interest rates could potentially increase sometime in 2015.

Don't fall victim to rising rates of inflation. There are ways to protect the value of your money and future purchasing power. Consider the following strategies to get started:

Reduce and pay off your debt. If you have substantial loans or debt with variable rates, it is important to consider paying them off or consolidating them, especially during times of rising inflation. When the interest rates begin to increase, so does a variable interest rate, meaning you'll be paying more for the items you currently have financed. Additionally, due to the decrease in the value of a dollar, you will be paying even more for items purchased in the past if financed.

Think about "real" assets. Real assets are tangible assets such as gold, property and commodities and tend to hold their value even in inflationary times. Gold and other precious metals have historically served as protection against currency devaluation. Consider diversifying your investment portfolio to include real assets or investment products based on real assets such as Real Estate Investment Trusts.

Outpace the inflation rate. Investing conservatively is fine, but you still may need to think twice about the "safety" in bank-issued certificates of deposit (CD) or other vehicles with set return rates of interest. According to Bankrate.com, the national average for a five-year CD is only .79 percent. Earning less than the inflation rate per year will cost you in purchasing power in the future. Consider exploring other safer alternatives with higher rates of return such as income annuities with an inflation rider.

Evaluate your securities. Certain equities can preform better than others in times of inflation. Energy, commodities and necessary items do better in times of inflation. Commodity-linked securities, such as exchange-traded funds or mutual funds, can perform better than those that are not. Another investment strategy to consider is Treasury Inflation-Protected Securities (TIPS). TIPS are linked to the CPI, so as the rate of inflation increases, so does the return on the investment. If deflation happens, the treasury pays the original or adjusted principal, whichever return is greater.

Retaining purchasing power is a particularly pressing concern in the current low interest rate environment. Low interest rates can make it difficult for conservative investors, including soon-to-be retirees and current retirees, to position their savings so that it keeps up with the rate of inflation.

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If investments don't grow at the annual rate of inflation, that money will be worth less in the future than it is now. Take for example, if an investor has $250,000 in savings and the inflation rate is 3 percent; in 20 years, he or she would need to have $451,527.81 just to maintain the same value.

This is why any indicators of inflation should not be ignored—inflation can eat away at your life's savings, potentially making it difficult to maintain your standard of living throughout the retirement years. While protecting your saved dollars is imperative, protecting the purchasing power of those saved dollars should be a priority too.

Each strategy mentioned may only be applicable to your situation if your age, timeline to retirement and risk tolerance are appropriate. For help deciding which inflation protection strategy is right for you, consult a qualified financial professional.

IS YOUR MONEY STUCK IN A LOW CD?

You may have options, and it pays to ask. Let's say you have a CD you want to put into your portfolio to be invested, hopefully for a higher return. You usually wait until maturity to avoid paying the six-month penalty that banks frequently impose. It makes sense when CD rates are high, but not always when they're low.

We called a bank for a client and discovered it charged a penalty of 18 months interest since the CD had an original two-year maturity. Fortunately, we were getting a decent enough interest rate, so waiting made sense. (Compare the interest income you'll earn over the months left to the penalty you'd pay).

Another new client had a 2.5-year, $10,000 bank CD earning 1.5 percent. We felt she could do better and thought a six month penalty at 1.5 percent would cost us $75. When we called, however, we discovered that there was no penalty since the CD was in an IRA account and our client was over 59 years old.

If you have funds tied up in a low interest CD and decide you can do better, talk to your bank and find out what the penalties are for early withdrawal.

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