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Inflation proof your portfolio

5 Tips: Inflation is rising but you can protect your investments from higher consumer prices.

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By Gerri Willis, CNN/Money contributing columnist

NEW YORK (CNN/Money) - The Federal Reserve hinted last week the economy might have a new enemy: Inflation.

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Worried about inflation? Gerri Willis offers 5 tips.
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While moderate inflation is natural in a growing economy, if prices rise too quickly it can hurt both businesses and consumers. That's the worry that Fed policymakers address.

How should you change your financial life to weather any potential rise in inflation?

Here are today's 5 Tips.

1. Check your 401(k).

Adjusting your 401(k) investments as the market environment changes is a good habit to have, but rising inflation makes it even more imperative.

The Fed is trying to contain inflation, but the economy is already showing signs of it. As a result, your returns in the stock market may not be as fruitful as in recent years.

History shows that stocks typically fare well when inflation is slowing, not rising, and that sharply rising inflation has triggered a sharp downturn in stocks.

But stocks are not the only investment that will feel a pinch from rising consumer prices. Alston Boyd, economic director at Martin Investors, says inflation also eats into bond returns.

The bread and butter of your portfolio -- stocks and bonds -- receive no assistance from inflation so your goal should be to salt your 401 (k) with more investments that can outpace inflation.

One thing to consider is buying an inflation-protected bond. They automatically pay more income as inflation rises. You can buy Treasury Inflation-Protected Securities, or TIPS, directly on the Treasury Department's Web site at www.treasurydirect.gov.

Vanguard offers an Inflation-Protected Securities Fund and Pimco offers a similar product, the Pimco Real Return Bond Fund.

For more help on adjusting your portfolio in a rising interest rate and inflationary environment, take a look at www.investoreducation.org.

2. Examine your home's true value.

If you already own a home, inflation will add to the value of what is probably your biggest asset. Think about it: Without any effort on your part, your house is more expensive.

If, however, you live in a market where prices have already soared you should examine whether your overall wealth is properly diversified.

Patrick Bajari, an associate professor of economics at Duke University, encourages homeowners to analyze the roots of those price increases. For example, did strong employment growth in the technology sector feed the housing boom in your town? If so, then re-allocate your 401(k) to make sure your overall wealth isn't completely dependent on the rising fortunes of the tech sector.

You'll have to do your own analysis of your market to ensure you have a good investment mix.

For buyers, however, a pernicious inflation may keep homeownership out of their reach, forcing them to either downsize their ambitions or delay a home purchase.

3. Ease debt worries.

If you carry a lot of fixed-rate debt such as home equity or car loans, you're about to get a break. Debt holders benefit when inflation rises because the value of the money they owe is shrinking over time.

Look at it this way: If inflation were to chug along at 5 percent or even 6 percent, the value of the money you borrowed yesterday would be far less than the money you're money you're borrowing today.

Think about swapping your variable-rate debt (home equity lines of credit or credit cards) for fixed-rate debt. That way, you benefit from an inflationary environment.

4. Watch your wages.

In a period of rising inflation, workers whose wages are stagnant lose ground. And while some employers may use inflationary periods to pass on their earning gains from price hikes to employees, it's just as likely your salary will stay the same, according to John Challenger, CEO of outplacement firm Challenger, Gray & Christmas.

Be your own agent by advocating for strong wage increases that will keep you ahead of inflation and reward you for your hard work.

5. Reality check.

Inflation can be harmful, but remember that it's all relative. Boyd doesn't see today's inflation of 3.6 percent as a big threat to consumers, especially when you consider that inflation spiked to 14.6 percent in the early 1980s.

Still, it's important to monitor whether prices are rising and how fast they are moving. A good way to do just that is to check the Consumer Price Index each month on CNN/Money's Economic Calendar. ■

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