

INVESTORS' EDGE

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HOW INFLATION COULD AFFECT YOUR INVESTMENT PORTFOLIO

For the past several years, inflation has been relatively low. The Consumer Price Index (CPI) actually fell for much of 2009 — the first year-to-year drop in decades. While you may not be concerned about the impact of inflation on your investments, things can change. If inflation starts taking off, it can be a real threat to your investment strategies — so it pays to be prepared.

Of course, inflation is somewhat unpredictable. On one hand, it may remain low, due to these factors:

■ High Unemployment —

Unemployment is as high as it's been in more than 25 years. People who aren't working have less money to spend, which lowers the demand for goods and services.

■ Under-Used Productive

Capacity — Currently, a sizable gap exists between what we are producing, given our equipment and infrastructure, and what we could be producing. Many economists believe that when this “slack” exists, the economy can expand without an increase in inflation.

■ Slow Velocity of Money —

Generally speaking, the faster the money supply moves through the economy, the greater the economic activity. The “velocity of money” is now fairly slow, which lessens the immediate threat of an overheated economy — a key determinant of inflation.

On the other hand, these elements could trigger inflation:

■ **Weak U.S. Dollar** — The U.S. dollar remains very weak. When importers have to pay more dollars for the same products, they may attempt to pass along these price increases to consumers.

■ High Level of Cash in

Economy — The economic stimulus package injected enormous amounts



of cash into the economy. At the same time, companies can borrow at low rates, although some financial institutions remain reluctant to lend. High cash levels and inexpensive borrowing can lead to the classic formula for inflation: too many dollars chasing too few goods.

What do such conflicting signals mean? No one has the definitive answer, of course, but most economists believe that inflation will remain low in the short term — but just how “short” that term is unknown.

Even when inflation is at near normal levels, over the long term, it can prove devastating to your purchasing power. If inflation averaged three percent a year, you'd pay about twice as much for goods and services in 25 years as you do today. And since you could easily spend two or three decades in retirement, you need to make sure your investment portfolio is positioned to handle an increase in the cost of living.

So, in the upcoming months, work with your Financial Consultant to review your current portfolio to see if it's positioned for low inflation in the short term and possibly higher inflation in the long term. At the same time, you may want to look for new opportunities. Specifically, keep a watchful eye on these types of investments:

■ Cash and Short-term

Vehicles — Cash, money market funds, and short-term vehicles, such as Treasury bills, were relatively

stable during the long bear market of 2008 and early 2009, so if you held these investments, your portfolio probably declined less than others. But if inflation heats up, you may want to consider Treasury Inflation Protected Securities (TIPS). As the name suggests, TIPS are Treasury securities and carry the full faith and credit guarantee of the U.S. Government. They are issued with fixed coupons and have maturities ranging from 5 to 30 years. Adjustments are made, up or down, to the principal amount to reflect changes in CPI.

■ **Bonds** — If the Federal Reserve thinks inflation is on the march, it may raise short-term interest rates. Rising interest rates negatively impact prices on outstanding bonds — referred to as interest rate risk — so investors could see prices on their current holdings fall. To protect yourself against interest-rate movements, you may want to consider a “ladder” containing bonds of varying maturities. If interest rates rise, you can reinvest the proceeds from maturing short-term bonds in new bonds at the higher rates. But if rates fall, you'll still benefit from owning longer-term bonds, which generally pay higher interest than short-term bonds.

■ **Stocks** — Inflation can be a mixed bag for stocks. On one hand, inflation is typically accompanied by rising interest rates — and when rates rise, it becomes more costly for companies to borrow to expand their operations, which can lead to reduced profits and lower stock prices. However, over the long term, inflation can allow companies to raise prices, boosting the dollar value of their sales and earnings. In any case, different market sectors respond differently to inflation and higher interest rates, so you'll want to review your equity holdings

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WEAK DOLLAR CAN MEAN STRONG INVESTMENT OPPORTUNITIES

You may be aware that the U.S. dollar has been weak, relative to other currencies. But the dollar's lack of strength doesn't mean there's a corresponding weakness in investment opportunities. In fact, by reviewing certain investment choices, you may be able to find a defense against the dollar's weakness.

Generally speaking, a weak dollar can lead to international investment opportunities. Why? Because these types of assets are appreciating in value, relative to the dollar, so when you sell your shares, your earnings are going to be worth more in U.S. dollars.

A weak dollar can also help you if you invest in American companies that do a sizable portion of their business internationally. The revenues these companies earn in local currencies become more valuable when translated into dollars. And the sheer volume of these firms' exports may go up, too, because, in a weak-dollar environment, their goods and services become less expensive to foreign customers.

Clearly then, as long as the dollar stays weak, you may want to look

beyond our borders for investment opportunities. However, you shouldn't add a large allocation of international investments to your portfolio and then assume you will get great results. Many investment experts recommend that you hold only a small percentage of your portfolio in foreign-based investments — although the actual amount depends on your individual risk tolerance, time horizon, long-term goals and other factors. You need to be careful about over-indulging in international investments as they carry their own set of risks, including the following:

- **Political Risk** — In the U.S., we tend to take political stability for granted. It's not always the norm in other parts of the world where new governments can come in, nationalize companies, drastically change policies or rules affecting commerce, or take other actions that could have a big effect on your investments.
- **Currency Risk** — A weak dollar can make foreign investments attractive, but when the dollar strengthens,

these same investments can lose value. Also, a foreign country's currency can lose value when the country experiences inflation.

- **Market Risk** — It's not always easy to judge the performance of international investments. For example, corporate reporting is not as tightly regulated in some foreign countries as it is in the U.S. Also, since accounting practices vary by country, it can sometimes be difficult to accurately assess the performance of a foreign investment.

Because of these risk factors, you may want to consider an index mutual fund or exchange-traded fund (ETF) that tracks U.S.-based indices, such as the S&P 500, because the stocks in some of these indices earn a significant part of their revenues internationally. These investment vehicles offer you a chance to participate in the international market while you diversify among industries and countries.

To learn more about international investing, please call. ■

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carefully to see if you need to make adjustments. Overall, the major U.S. equity indexes have historically performed poorly during periods of high inflation, but performed well during periods of modest inflation.

- **Alternative Investments** — Some types of alternative investments, such as real estate and commodities (precious metals, raw materials, grains and so on), are often viewed as a hedge against inflation. So, if inflation does take off, you may want to consider including a limited amount of these investments to your portfolio. One possible way to add a diversified array of commodities is through shares in a commodities mutual fund or an exchange-traded fund (ETF) that tracks individual indices or a basket of several commodities. Keep in mind, though, that alternative investments can be both volatile and complex, so make sure you thoroughly understand those vehicles.

Please call to learn more about investments and strategies for dealing with inflation. ■

MAX OUT YOUR IRA AS EARLY AS POSSIBLE

Although you have until next April to contribute to your IRA for the 2010 tax year, you might be doing yourself a favor by contributing as much as you can as early as you can. The sooner in the year you contribute to your IRA, the more time you'll give your money to grow. You may not think this extra compounding time will make much of a difference, but if it's repeated over the course of years or decades, you could end up with more money when it's time to start taking withdrawals.

In 2010, you can put in up to \$5,000 to your traditional or Roth IRA, or \$6,000 if you're 50 or older.

And starting this year, it may be easier for you to convert assets from a traditional IRA, which grows on a tax-deferred basis, to a Roth IRA, which can grow tax-free, provided you've had your account at least five years and you don't start taking withdrawals until you're at least 59½. Under the old rules, you could convert from a traditional to a Roth IRA if your modified adjusted gross

income (MAGI) was \$100,000 or less. In 2010, you can convert funds to a Roth IRA even if your MAGI is over \$100,000.

Keep in mind, though, that when you convert a traditional IRA to a Roth IRA, you'll have to pay ordinary income taxes on previously untaxed traditional IRA proceeds. However, if you convert in 2010, you can report the taxable income from the conversion over a two-year period, in 2011 and 2012. Also, if you take the money from your traditional IRA to pay these taxes, and you're under 59½, you may have to pay a 10 percent penalty tax.

You may want to consult with your tax advisor to determine if a Roth IRA conversion makes sense for you. But regardless of the IRA you have, try to fully fund it as early in the year as possible.

If you have questions about IRA contributions or Roth Conversions, please call. ■

WATCH FOR CHANGE IN INVESTMENT TAX RATES

Even though we're still in the first half of 2010, it's not too soon to start making investment moves for 2011 and beyond. And as you ponder these moves, you'll want to pay special attention to two key areas: dividends and capital gains.

Currently, both dividends and long-term capital gains are taxed at a maximum rate of 15 percent. But these rates are set to expire on December 31, 2010. What will take their place? We don't know at this point, but it seems likely that you can expect higher tax rates on long-term capital gains and dividends, especially if you're in one of the higher tax brackets.

What changes should you make in anticipation of, or in response to, these new rates? For starters, don't give up on dividend-paying stocks. Even at the higher tax level, the dividends you receive can be valuable to you, whether you take them to boost your cash flow or reinvest them to increase your ownership shares. Furthermore, dividend-paying stocks often offer the potential for significant growth. And as for capital gains, you shouldn't sell investments before you've held them a year for the sole purpose of taking short-term capital gains, because these gains will still, in all likelihood, be taxed at a higher rate than long-term gains.

However, you may want to make some moves, such as re-evaluating which investments go into your tax-advantaged accounts, such as your IRA and 401(k), and which ones go into your taxable accounts.

When dividend-paying stocks and low-turnover stock-based mutual funds (which typically generate long-term capital gains) were being taxed at the relatively low 15 percent rate, you might have wanted to keep them in taxable accounts, leaving more room in your tax-advantaged accounts for investments such as bonds that generated income taxed at your ordinary income tax level, which is likely considerably higher than the 15 percent rate.

But if the tax rate on dividends and long-term capital gains increases substantially, you might want to consider putting your dividend-paying stocks and low-turnover funds into a Roth IRA, where you pay no taxes on earnings, provided you meet certain conditions, or into a traditional IRA or 401(k), where you can defer taxes until many years later, when you may be in a lower tax bracket, possibly during retirement.

Aside from possibly changing the investment mix in your tax-advantaged and taxable accounts, what else might you do in response to an increase in tax rates on dividends and long-term capital gains? If you're in one of the upper tax brackets, you could benefit from investing in municipal bonds, either individually or in mutual funds. As you may know, the interest income from "munis" is typically exempt from federal taxes and may be exempt from state and local taxes, too, depending on where you live. However, some municipal bonds may be subject to the alternative minimum tax.

You might also consider investing in potentially high yielding securities that never qualified for the lower dividend rate, such as real estate investment trusts (REITs) or preferred stock.

Apart from exploring your immediate investment moves, what other steps should you take if tax rates rise on dividends and long-term capital gains? For one thing, you may want to review your estate transfer plans — specifically, your gifting strategies.

Gifting during lifetime is, of course, a common method of reducing the size of one's taxable estate. And when dividend-paying stocks and investments



that throw off long-term capital gains were taxed at the low 15 percent rate, these vehicles were ideal gifts, because they lowered your estate's value without burdening your children or other recipients with high taxes.

But if the tax rates do increase on these investments, you may want to look for alternative gifts. At the very least, though, you'll want to make sure that whoever you designate to receive these gifts is capable of paying the higher taxes that may be due if the recipient sells the investments.

In any case, since changes in tax rates on dividends and capital gains may be coming in 2011, you'll want to start reviewing your options soon. The more familiar you are with the possibilities, the better choices you're likely to make. ■

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