HOW TO BEAT INFLATION

Today oil and gold prices are flirting with their all-time highs. Oil touched $111 a barrel on March 17, 2008 while gold touched Rs 13,000 in March. The stock markets, which had once conquered the dizzy heights of 20,918 on January 14, are still reeling from the downturn caused by global turmoil. Interest rates on savings account and other term deposits are giving negative real rates of returns. As if all this wasn't enough, we now have a daunting inflation rate of 7 per cent.

According to the latest data, the wholesale price index (WPI) is up 7 per cent over its level last year at this point of time. But remember that the WPI does not capture the full extent of the price rise we face today. If we prepare a WPI for the basket of goods that we actually consume (instead of the basket of goods included in the index), the inflation figure might be much higher

Inflation is a double-headed monster: not only does it demand a higher allocation of current resources to meet immediate needs, it also whittles away at your investment returns. The biggest challenge before investors today is how to make their investments inflation proof.

Cause and effect

What has caused this drastic, headline-hitting, surge in inflation? According to Ajay Bagga, chief executive officer, Lotus India AMC, "Inflation has got imported into our country. The rise in global prices of commodities, including agricultural goods, metals and crude oil is stoking domestic prices." Subir Gokarn, chief economist, S&P (Asia Pacific) concurs. "Present inflation is due to the mismatch in demand and supply of commodities at the global level," he says.

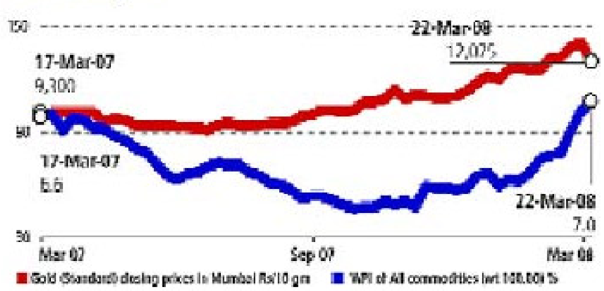
Faced with several assembly elections during the year and a general election next year, the government can't allow inflation to dent its electoral prospects. It has hence acted with alacrity, reducing import duty on edible oils, banning the export of non-basmati rice, and even persuading steel manufacturers to roll back price hikes.

Tweak your portfolio in favour of investments that beat inflation

Type of investment	Money invested for 1 yr	Rate of return (%) [2]	Tax rate (%)	Likely return
Sensex	100	22.5	0	122.5
Gold ETF	100	22.4	No LTCG	122.4
Diversified equity funds	100	20.6	No LTCG	120.6
Inflation [1]	**100**	**7.0**		**107**
Term deposits	100	8	5.3	105.3
PPF	100	8	5.3	105.3
Post Office Monthly Scheme	100	8	5.3	105.3
Debt funds	100	7.5	4.9	104.9
Savings account	100	3.5	3.5	103.5

[1] Inflation represents the change in the prices of a basket of commodities over a year; [2] All rates of return figures are for the last one year

How gold fared against inflation during the last one year



Since fiscal measures alone are unlikely to suffice, monetary measures are expected to follow. As HDFC chairman Deepak Parekh says, “Reserve Bank of India will have to take some steps to contain inflation by using the monetary mechanism.” It is widely expected that the RBI will hike either the CRR rate or the repo rate in the credit policy review due at the end of April.

Not everyone is optimistic that the government and the RBI will succeed in taming inflation, which is a global, and not just a domestic, phenomenon. Says Gokarn: “While measures taken by the government might help in the short term, in the long term the inflationary pressures will persist.”

Impact on investments

How does inflation impact your investments? Normally, while calculating returns, investors don’t take inflation, and also taxes, into account, both of which erode investment returns.

Here’s an example. An investment of Rs 10,000 in a term deposit with a return of 8 per cent will fetch you Rs 10,800 after a year. But is this Rs 800 return for real? After taking into account the 7 per cent inflation, the real rate of interest dips to 1 per cent (8 per cent less 7 per cent). Such deposits also invite tax liability. Once you factor in taxes as well (say, 33 per cent), your returns fall by another Rs 264. Thus, your real rate of return is actually negative.

The impact of inflation really depends on the investment portfolio you maintain. Keeping your money in a savings account that offers a measly 3.5 per cent return is counter-productive. If you are a conservative investor with investments chiefly in low-risk (or no-risk) instruments such as a term deposit, public provident fund, or post office monthly income scheme, which give approximately an 8 per cent rate of return, then the current high rate of inflation ought to give you sleepless nights. As Surya Bhatia, a Delhi-based financial planner says, “As a growing economy, we have to get used to high rates of inflation. And against a backdrop of high inflation if a person makes investment only in debt instruments, he is more likely to compound losses than generate wealth,” The current spike in inflation should hence galvanise you into changing your portfolio composition so that your investments are better able to cope with inflation.