Inflation can spoil your investment party in 2021. But there is way to beat it

By NIKHIL WALAVALKAR

The after-effects of all that easy money supplied by central banks across the world to fight the COVID-19 slowdown are showing up finally. A rising inflation is now a big threat to your purchasing power, more so to your investment portfolio. While the inflation in the US touched the 5 percent mark, India's consumer price index was 6.3 percent. A recent fund manager survey done by Bank of America says that only 23 percent expect inflation to be permanent. But that should be enough for investors to sit and take notice. Here's how you can be better prepared.

Bonds: The main victim of high inflation

In 2019 and 2020, long-term debt and government securities (g-sec) funds gave 11 percent returns. It was a great time to be invested in such debt funds when interest rates were falling. But things may get tighter, now that inflation is rising steadily.

A low interest rate and high inflation combination is bad for investment returns. Although debt funds give tax-efficient returns as compared to bank fixed deposits and small-saving instruments, their post-tax yields during low interest rates are quite low. Worse: if interest rates rise, then these funds may decline in value. "Fixed income investors should avoid locking in money for the long term. Instead, they must stick to liquid funds to benefit from gradual increase in interest rates in future," says Arvind Chari, CIO, Quantum Advisors.

Here are two alternative strategies for your fixed income allocation:

If you have money to park for the short run, liquid and overnight funds are still tax-efficient, especially if you fall in the highest income-tax bracket. Stick to short-duration debt funds, if you want to park your money for smaller timeframes.

Avoid chasing high yields in fixed income, via, say, credit risk funds. These funds come with higher risks. Use debt funds to balance your overall portfolio's risk, not to earn higher returns.

Feroze Azeez, Deputy CEO, Anand Rathi Wealth Management says, "Though rising inflation lowers the real yield on bonds, it also enhances the indexation benefit. Bond funds work due to their indexation benefits." Dhaval Kapadia, Director-Managed Portfolios, Morningstar Investment Adviser India, recommends investments in instruments offering floating interest rates, such as RBI Floating Rate Saving Bonds

Good time to buy a house

Some experts say that in inflationary times, prices of real assets such as land, real estate, gold tend to rise. Ritesh Jain, Ex-chief Investment officer and blogger at WorldOutOfWhack.com says, "That's a good time to buy a residential property with a home loan, if your cash-flow permits."

If you wish to buy a house for consumption, then this is as good a time as any. But if you wish to invest in real estate, do your research well. Vishal Dhawan, Founder and Chief Financial Planner, Plan Ahead Wealth Advisors says, "Investors would be better off investing through real estate investment trusts (REIT), as they offer access to high-quality commercial real estate assets and you also enjoy intermittent liquidity."

Jain believes an allocation to gold works well, too, in high inflationary times.

Don't ignore equities

Although equity returns are typically far higher than inflation, investing in stocks now is easier said than done. The S&P BSE Sensex is near record highs. The index has delivered a one-year return of 49 percent and five-year annual return of 15 percent. Is this a time for correction, then?

Chari says that a correction at this point is good news. "To tackle inflation, central bankers may choose to gradually tighten liquidity and eventually hike rates. This could lead to money flowing out of equities and into bonds. That's a good entry point in equities," he says, adding that in the medium term, reasonable inflation leads to high nominal growth and tends to be good for equities.

Don’t fall for the temptation of thematic or sector funds. Stick to diversified funds, instead. Shridatta Bhandwaldar, Head Equities, Canara Robeco Mutual Fund says, “In inflationary times, businesses with pricing power tend to do well. Investors may also make money with quality cyclical stocks.”

“Avoid any knee-jerk reaction. Inflation is also cyclical and so do not go overboard on any particular asset class or investment,” says Dhawan.