



How to Build a Portfolio Wisely and Safely

Inflation or deflation?

Even the experts can't agree whether rising or falling prices lie in our future.

That leaves investors in a quandary: how to construct a portfolio at a time of great uncertainty.

A wrong bet could be devastating. If your portfolio is built for deflation, for example, your assets will slump if the country instead experiences a bout of inflation.

The answer is to prepare for the economic scenario you think is most likely, and then build in some insurance in case you are wrong.

"If you want to win the war," says Rich Rosso, a financial consultant at Charles Schwab, "you have to own both sides of the fight to some degree."

Such an approach necessarily means some investments will suffer no matter how the economy turns. That is OK: Buying insurance doesn't mean you actually want to use it.

Here are three portfolios, each with built-in insurance. The first will do best in an inflationary period but won't be crushed if deflation instead rules the day. The second

Defensive Portfolios

Investors must invest based on the economy they think is most likely, but build in some insurance just in case the opposite occurs.

	INFLATION-CENTRIC	DEFLATION-CENTRIC	GOLDILOCKS ECONOMY
	25% Commodity ETF	35% Long-term Treasurys	20% U.S. equities
	15% Cash		20% Foreign equities
	15% TIPS	20% Cash	30% Bonds (Vanguard bond index fund)
	10% REITs	15% Municipal bonds	
	Equities: 15% U.S.	5% TIPS	10% Long-term Treasurys
	5% Foreign	15% Commodity ETF	10% Commodity ETF
Insurance	10% Municipal bonds	10% U.S. equities	10% Cash
	5% Treasurys		

Source: WSJ research

is for investors who fear deflation, but want some protection against potential inflation -- even if it is down the road. And the third is aimed at investors who believe the economy will muddle through without severe inflation or deflation.

Inflation

If you believe all the government spending in response to the financial crisis will ultimately beget inflation, you want a portfolio that thrives in a period of surging prices.



Commodities are the primary play, because everything from oil and corn to copper and pork bellies should gain. Plus, commodities -- particularly gold -- hedge against the dollar, offering a 2-for-1 benefit if a weak dollar accompanies inflation, as some expect.

Since commodities contracts can be a hassle for individual investors, consider a fund such as Pimco's CommodityRealReturn Strategy Fund, which offers exposure to a broad swath of industrial and agricultural commodities.

Though it seems counterintuitive, cash can do pretty well, too. The Federal Reserve would likely fight rising inflation by pushing up short-term interest rates, allowing investors with cash to capture the escalating rates through short-term certificates of deposit and money-market accounts.

Michele Gambera, chief economist at Ibbotson Associates, says his research shows that in the last five bouts of meaningful inflation, returns on cash essentially matched the inflation rate, meaning it isn't losing its purchasing power. Online banks and local credit unions tend to offer the highest rates.

Treasury inflation-protected securities, or TIPS, are an obvious investment since their principal adjusts upward along with inflation. TIPS exposure is available through mutual funds, such as the Vanguard Inflation-Protected Securities Fund, though Steven Fox, director of forecasting at Russell Investments, notes that holding individual bonds to maturity is more effective as an inflation hedge since "the majority of the inflation protection comes when the inflated principal is repaid." Individual TIPS are available through brokerage firms or TreasuryDirect.gov.

Sharp inflation is generally a negative for stocks, because rising interest rates potentially pinch corporate profits and undermine economic growth. But a few stocks will likely do fine. Start with energy and metals stocks because higher prices for their commodities will boost earnings, says Mark Kiesel, a managing director at Pacific Investment Management Co., or Pimco. Include as well U.S. firms with pricing power, such as regulated utilities, domestic pipeline companies and manufacturers of specialty materials. Examples of companies to consider: miners such as Freeport-McMoRan Copper & Gold and energy giant Exxon Mobil, or companies indirectly tied to commodity prices, such as driller Diamond Offshore Drilling, farm-equipment company Deere and seed supplier Monsanto.

Insurance Component: Long-term Treasury bonds and municipal bonds.

Both will likely soar in value amid deflation because their long period of fixed payments would be an attractive source of income as prices for goods and services broadly fall, and as

paychecks shrink. And Treasuries, in particular, would likely become a haven for foreign investors, further pushing up their price.

Deflation

Portfolio preparation is easier for deflationists: Put a chunk of money into long-term Treasury bonds and much of the rest into cash and some municipal bonds.



If broad-based deflation materializes, long-term Treasuries are likely to surge. The bonds' fixed-income stream, meanwhile, would be worth increasingly more relative to falling consumer prices.

Some investment-grade municipal bonds could serve a similar role while also providing tax advantages for high-income earners. But beware: Deflation would likely mean some taxing authorities struggle to service bonds reliant on a specific income stream, like user fees. Instead, stick to "investment-grade bonds tied to necessary services like water and sewage, power or necessary government offices like, say, a courthouse

building," says Marilyn Cohen, president of bond-investment firm Envision Capital.

Round out your deflation portfolio with a big slug of cash. Though it won't generate much of a return in a low-rate, deflationary environment, cash in the bank will gain value as prices fall.

Insurance Component: Commodities react most drastically to surprise inflation, so they should be part of your insurance. Add in TIPS, too, and stocks geared "toward consumer-staple companies," says Ibbotson's Mr. Gambera. If inflation arises, companies such as Coca-Cola, tobacco giant Altria, and toothpaste maker Colgate-Palmolive will have some pricing power.

Goldilocks Economy

Maybe, just maybe, world bankers will get this right, and the economy will experience neither severe inflation nor severe deflation.



"We think most likely the central banks of the world will get this close enough to right that we will settle in close" to a relatively benign inflation rate of between 1.5% and 2.5%, says Aaron Gurwitz, head of global investment strategy at Barclays Wealth.

In such a "Goldilocks" scenario -- where the economy is neither too hot nor too cold -- "risky assets would do best, so equities and bonds with some equity characteristics should receive the emphasis," says Scott Wolle, portfolio manager of the AIM Balanced-Risk Allocation Fund.

That means broad exposure to large-cap and small-cap U.S. stocks through funds such as the Vanguard 500 Index Fund or the Bridgeway Small-Cap Value fund; and exposure to developed and emerging markets through funds like the Vanguard Total International Stock Index Fund (mainly developed markets), and the T. Rowe Price Emerging Markets Stock Fund.

For the bond component, pick a fund such as the Fidelity Total Bond fund that largely owns high-grade, intermediate-term corporate bonds and mortgages, along with government and agency debt.

Insurance Component: Just in case the Goldilocks scenario is wrong, you will need insurance against either inflation or deflation. Pick up inflation protection through a commodity ETF, and deflation protection with long-term Treasuries. Cash also is OK in either situation.

By Jeff D. Opdyke