

Diversifying to Beat Inflation and Higher Taxes

by Chris Miller, MBA

My financial practice, along with the portfolios of my clients, focuses on hard assets. Hard assets are backed by something tangible such as real estate, petroleum products, or gold. I concentrate on the first two mentioned because I prefer investments that seek to potentially create income, tax savings, and growth.

As many of my clients focus their portfolios on hard assets as well, this article may just be “preaching to the choir.” For those with some stock holdings, stock prices today could present an opportunity to “cut your losses,” and reposition your assets to a sector that can perform well over the next few years.

As the stock market declined between September of 2008 and March of 2009, many investors said “When the market comes back, I am cutting my losses.” Today just may be an opportunity to do so.

What The Stock Market Has Done

During the week of December 27, 1999, the Dow Jones Industrial Average peaked at 11,391. On December 24 of 2009, the Dow closed at 10,471 for an average annual return of just under 1% for that 10-year period. Sure, one could have bought at the low of 7,701 (September, 2002) and sold at the high of 14,066 (October, 2007) for a 12.8% annualized rate of return, but this would require perfect timing. And – this is the most important part – you needed to take your money out of the market when you sold. Most investors “captured gains” by selling stocks in 2007, and bought other stocks with them. The effect of this was “booking” profits - then watching them evaporate over the next two years. The only “winners” in those situations were state and federal governments – who collected capital gains taxes.

What Do You Think the Economy Will Do?

Just as the prices of oil, gasoline, and bread will undoubtedly hit a new “all time high” at some point in the future, the stock market will too. The big question for the market is “When will we hit this high?”

If you think that the US economy will see explosive growth, spurred by more government spending, regulation, and taxation, then you may want to buy stocks today and “cash in” two years from now. If you, like me, believe that the economy may be slow for the next few years; then you may want to pull some of your stock market money off the table in favor of other assets.

While more government regulation and taxation will do their part to slow economic growth, the current administration’s goal of “spending our way out of this recession” may very well lead to inflation. While inflation is generally harmful to the stock market (see the market’s performance in the 1970’s for an example), hard assets such as commercial real estate and petroleum production can perhaps outperform certain other investment types in this environment.

Commercial Properties

Many commercial properties have rent increases built into their lease contracts to keep up with inflation. \$10,000 won’t buy as much ten years from now as it will today, so increasing rent is preferable to landlords. Some properties have “CPI rental increases” built in their leases. With

such a lease, the rental rate increases every year by the actual amount of inflation. Other leases will have a set annual rent increase, such as 3% or 5%.

Commercial property values, of course, are based on the amount of income they generate. Property owners can write rental increases into their lease contracts to seek growth during inflationary times, as well as monthly income checks.

Energy Investments

For energy investments, I prefer domestic oil and natural gas production – as either royalty or developmental interests. Let's say that I, as an investor, own a barrel of oil. If the dollar becomes worth less as a result of inflation, I will receive more dollars in exchange for my barrel of oil. In this way, my investment has the potential to stay ahead of inflation's damaging effects.

Tax Benefits Too

In a recent article, I wrote about how we are facing the “double whammy” of higher taxes AND higher inflation. The government's monetary programs are helping to make the dollars we earn worth less. At the same time, the government wants a higher “cut” of our income. If I were more cynical, I would conclude that the government is “raising rents to keep ahead of inflation.” Hard asset investments, depending on the specific product purchased, can potentially provide immediate tax savings or tax-sheltered income. If you are concerned by this “double whammy” effect on your income, then hard asset investments may be something worth learning about.

Christopher Miller is a Managing Director with Specialized Wealth Management in Orange County, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313-1868.

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