

Managing INFLATION RISK

Less than twelve months ago, in anticipation of the inflationary effects of rising federal spending and debt, investors were asking how they could prepare for “near-certain” inflation. Today, inflation is below 1% and deflation fears abound.

Which will it be: inflation or deflation?

Unfortunately, no one knows how to accurately predict whether the cost of living will rise or fall and by how much. In 1979, as U.S. inflation was peaking, most experts predicted that it would stay high for years to come. Three years later, in 1982, inflation had dropped from 13.2% to 3.8%.

While it may be tempting to try to get the inflation or deflation question right, the odds are against you. The better plan is to spread your investments amongst those that fight inflation and those that combat deflation.

In building such a portfolio, one should recognize the difference between expected and unexpected inflation. In our view, markets efficiently integrate all known information into securities prices. Thus, current prices already reflect expectations of future inflation. Only unexpected news will affect the inflation outlook. Today’s bond prices, for example, already reflect expectations for tomorrow’s business conditions and inflation.

Hedging vs. Total Return Strategies

Investors can prepare for unexpected inflation by following one of two basic strategies—hedging against the immediate effects of inflation or earning a total return that outpaces inflation over time.

Hedging involves choosing assets whose value tends to rise with inflation. Although holding these assets may reduce the return of a portfolio, the positive correlation with inflation can help an investor keep up with rising consumer prices, at least over the short term. Those who could consider hedging include retirees, fixed income investors, and others who would experience a diminished living standard during an inflationary period. These investors may be willing to forfeit long-term growth potential for more immediate inflation protection.

In a total return strategy, an investor attempts to outpace inflation by holding assets that are expected to earn higher real (inflation-adjusted) returns. This investor is willing to give up short-term inflation protection for an opportunity to grow real wealth. Younger investors are typically well suited for this strategy because they have many years until retirement and expect their earnings to advance faster than the inflation rate.

Most investors can benefit by including both hedging and total-return strategies in their portfolio. To do so, their portfolios should employ some combination of stocks, short-term fixed income, commodities and Treasury Inflation-Protected Securities (TIPS). Let’s consider the benefits of each of these:

• **Stocks**

From 1930 through 2009, the total US stock market, as measured by the S&P 500 Index, outpaced inflation by an average of 6.2% per year. To achieve this higher expected real return in stocks, however, an investor had to accept more risk, and endure periods when stocks did not outpace inflation. As a result, stocks may be less effective for hedging short-term inflation but are expected to beat long-term inflation by earning a higher total return.

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WHO IS LOOKING OUT

for Your Best Interests?

When you work with your financial advisor, you probably expect that he or she will give you a recommendation that is in your best interest.

While that may be your expectation, not all advisors are held to a fiduciary standard. The most basic definition of a fiduciary is “someone who puts the client’s interest ahead of his own”. Investors work with multiple types of professional advisors. Between their insurance agent, estate planning attorney, accountant, broker, investment adviser and financial planner, a consumer could be fielding advice from any number of professionals who all are held to differing standards.

Currently there is much debate in the financial services industry over whether or not all financial advisors should be held to a fiduciary standard, since presently they are not. In conjunction with the newly enacted Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress has asked the Securities and Exchange Commission (SEC) to conduct a study and seek comments from the public to determine whether or not all financial advisors should be held to the same fiduciary standard. Some 2,500 comments are being reviewed as of this writing.

The National Association of Personal Financial Advisors (NAPFA), the nation’s leading organization of fee-only comprehensive financial planning professionals, has adopted the following,

Robin Sherwood admitted to NAPFA

HTG is pleased to announce that Robin has been admitted as a member of the National Association of Personal Financial Advisors (NAPFA). NAPFA is a non-profit, member organization dedicated to the practice of Fee-Only financial planning. Membership in NAPFA is limited to financial advisors who are paid directly by their clients, adhere to strict ethical standards, and who submit a complete comprehensive financial plan for full-scale peer review. NAPFA members must meet the industry’s most rigorous education and training requirements.



For more information about NAPFA, please visit www.napfa.org.

more comprehensive definition of a fiduciary: “A financial advisor held to a fiduciary standard occupies a position of special trust and confidence when working with a client. As a fiduciary, the financial advisor is required to act with undivided loyalty to the client. This includes disclosure of how the financial advisor is to be compensated and any corresponding conflicts of interest.”

One of the best ways to determine if your financial advisor is held to a fiduciary standard is to find out how he or she is compensated. The fee-only model minimizes conflicts of interest. A fee-only financial advisor charges clients directly for his or her advice and/or ongoing management. The advisor receives no other financial reward, directly or indirectly, from any other source. Fee-only financial advisors are “selling” only their knowledge, advice, and service.

If an advisor receives compensation based on the investments they recommend to clients, receives referral fees from other professionals such as attorneys or mortgage brokers, or receives commissions or other financial incentives for recommending certain financial products, they may not be acting in a fiduciary capacity. NAPFA has developed a questionnaire to help consumers assess whether a prospective financial advisor will act in their fiduciary interest. This questionnaire is accessible at: www.focusonfiduciary.com/fiduciary_questionnaire.htm.

Federal and state law requires that Registered Investment Advisors are held to a fiduciary standard. This law requires that an advisor act solely in the best interest of the client, even if that interest is in conflict with the advisor’s financial interest. Registered Investment Advisors must disclose any conflict, or potential conflict, to the client prior to and throughout a business engagement, and they must adopt a Code of Ethics and fully disclose how they are compensated.

Whether you are considering a potential financial advisor or evaluating your current advisor, ask them what standard they meet and have them put it in writing. You don’t have to wait for reform to be certain that your interests come first. ♦



H. Thomas Gnuse, Principal, CEO

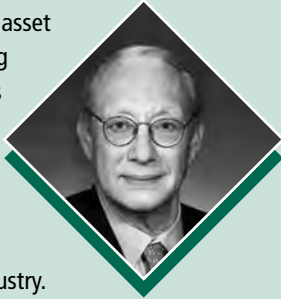
Tom founded HTG Investment Advisors Inc. in 1993. He serves as CEO and Chief Investment Officer of the firm. He has extensive background in the theory and practice of portfolio design employing the principles of strategic asset allocation and diversification. Since founding HTG, Tom has worked with numerous clients to address a wide range of financial situations and goals.

Tom brings planning and management experience from his earlier careers in the corporate world and the venture capital industry.

Prior to founding HTG, he was a general partner of three venture capital funds where he managed investments and served on the board of directors of several early-stage companies. Earlier, Tom was an executive at NCR Corporation where he directed product and strategic planning for the firm's worldwide business in the financial industry and was general manager of a major business unit. He also served for three years as an officer in the United States Air Force.

Tom earned an MBA degree with distinction at Harvard Business School, where he was selected as a Baker Scholar. He obtained his MS degree in Engineering at UCLA; and graduated summa cum laude at Duke University, where he earned his BSEE degree.

Tom's community activities include membership in the Exchange Club of New Canaan, St. Mark's Church, and the Board of Directors of the United Way of New Canaan. Other personal interests include travel, reading, golf, and skiing.



Sue Lione

Sue joined HTG in 1997. As an advisor, Sue enjoys working directly with clients to help them achieve their goals. She also oversees many administrative and operational functions in the office, and she is invaluable as our in-house tech liaison.

Sue worked in the investment industry for seven years prior to joining HTG, including J.P. Morgan's investment advisory department, and later as a portfolio manager at Union Trust Company. Sue has her BA in Economics from Immaculata University. She is Series 65 registered and completed the CFP course of study. She is a licensed real estate agent in the state of Connecticut and has five years experience in the field.

Sue is active in the community as Chairman of the Pastoral Advisory Council at St. Aloysius Church, and she is past Chairman of the United Way of New Canaan. Sue enjoys tennis, skiing, and her grandchildren.



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• Fixed Income (Bonds)

Higher inflation can hurt bondholders in two ways—through falling bond market values triggered by rising interest rates (which frequently accompany inflation), and through erosion in the real value of interest payments and principal at maturity. This risk tends to negatively impact long-term bonds more than short-term bonds, so investors can mitigate the effects of rising interest rates by holding shorter-term instruments.

• Treasury Inflation-Protected Securities (TIPS)

Issued by the US government, TIPS are fixed income securities whose principal is adjusted to reflect changes in the Consumer Price Index (CPI). In addition, TIPS are a good portfolio diversifier for some long-term investors due to their negative correlation with equities and relatively low correlation with most types of fixed income assets.

• Commodities

Commodity futures, as well as precious metals and oil, are perceived as effective inflation hedges because their returns are positively correlated with inflation. In addition, their usual low correlation with other asset classes makes them an effective source of diversification.

Deflation

In deflationary times, prices and wages fall; interest rates are very low. While cash buys more in the future as prices fall, it produces little income. Top-quality bonds are an ally in this environment. Some stocks may be hurt, if they cannot maintain prices, or if they are leveraged, since the real cost of debt is increasing. However, other stocks may benefit as weaker ones falter. Hard assets such as real estate and commodities will likely face declines.

Investors are advised to defend against deflation by having intermediate to long-term bonds in high quality corporate, government and municipal debt, complimented by high quality stocks.

Summary

No one really knows how consumer prices will respond to the complex forces at work in the economy and markets. As usual, portfolios should be diversified to provide a balance between protection and opportunity over a wide variety of possible scenarios. ♦



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HTG news

- ◆ Robin Sherwood recently attended two Dimensional Fund Advisors (DFA) seminars. The first focused on the “science of investing” and explored DFA’s approach to building passive, highly efficient portfolios of stocks and bonds from around the world. In the second conference, DFA introduced the idea of building custom 401(k)s at a reasonable cost using DFA funds.
- ◆ Tom and Jeanne Gnuse traveled with Harvard Business School classmates through several Eastern Bloc countries this summer. Their journey ranged from long-suffering rural areas in the Black Sea regions of Romania and Bulgaria westward to more prosperous capital cities, Budapest and Bratislava. While the European Union provides hope for better times, the global recession has taken a heavy toll as these countries still struggle to recover from the abject failure of Soviet-style socialism.



- ◆ HTG’s annual summer outing included a fun afternoon of kayaking on the Five Mile River followed by a picnic dinner at Roton Point. A good time was had by all!
- ◆ Jennifer and Luciano Nicasio are thrilled to announce the marriage of their daughter, Lauryn, to Conor Soden. The couple were married in Greensboro, Vermont on Saturday, September 18. The bride and groom met at Middlebury College and will be residing in New York City.