

Treasury Inflation Protection Securities (TIPS)

Treasury Inflation Protection Securities (TIPS) are treasury notes or bonds that are indexed for inflation. They were first issued in early 1997. Their purpose is to provide investors with a fixed income alternative that is protected from the erosion of inflation over time.

The value of TIPS is automatically adjusted to the inflation rate as measured by the Consumer Price Index (CPI). If the CPI goes up by half a percent, the par value of the bond would go up by half a percent. If the CPI falls, the par value of the bond will fall, but not below the issue price, because the government guarantees that the maturity value will be at least equal to the issue price. With that being said, if you sell your TIPS on the secondary market, there is a chance that you could receive less than issue price or par value, due to year-to-year fluctuations in the market. Investors who buy TIPS in the secondary market at a price above the original issue price could also suffer a loss due to deflation even if they hold the bonds to maturity.

In the right circumstance, TIPS can be very useful. However, purchasing Treasury Inflation Index Securities comes at a cost. Following are some of the disadvantages of TIPS:

- *Interest Rate - The interest rate paid by these securities is lower than similar treasury securities without the inflation protection.*
- *Taxes - You are liable for federal taxes on the inflation adjustment unless you own these securities in a tax-deferred or non-taxable account.*
- *Tradability - TIPS aren't as easy to trade on the open market as non-indexed treasuries.*
- *CPI Calculation - Many economists, including Greenspan, feel the CPI is overstated. If the government decides to switch to another inflation measure, then the inflation adjustment may not be as valuable.*

Looking at TIPS opportunistically, we will do better in TIPS if inflation is higher than expected and better in Treasury notes if inflation is lower than expected. For example, as of October 28, 2004 the yield to maturity on the TIPS due April 2032 was 2.06% while the yield to maturity on the Treasury notes due February 2031 was 4.79%. Therefore, the TIPS due April 2032 were being priced based on the expectation that inflation will be about 2.7% ($4.79\% - 2.06\% = 2.73\%$).*

If the inflation rate during that period is greater than 2.7%, investors in TIPS will fare better than investors in Treasury notes. Conversely, if the inflation rate is less than 2.7%, investors in Treasury notes will enjoy higher returns than investors in TIPS.

Whether an individual investor should invest in TIPS depends on his or her investment objectives. An investor who wishes to lock in a very modest inflation adjusted return through April 2032 might find the TIPS due April 2032 very appealing. From 1925 through 2003, Treasury Bonds returned 5.4% and inflation averaged 3.0%. That is an inflation adjusted return of about 2.4%. This is a little higher than the current yield to maturity on the TIPS due April 2032 of 2.06%.

It may be a coincidence that the current yield to maturity on TIPS is a little lower than the historic inflation adjusted return on long-term Treasury notes, but it makes sense that it should be. Since TIPS are protected from the risk of inflation and Treasury notes are subject to that risk, one would expect long-term TIPS to yield a bit less than Treasury notes, because we all know that less risk should result in lower returns.

At Resource Consulting Group, we have used TIPS on an extremely limited basis. TIPS are not part of the fixed income allocation of most accounts. The reason for this is that we view fixed income as a means by which to dampen volatility and a source of liquidity. TIPS are not ideally suited to either of these purposes. However, TIPS might be appealing to an investor who wants to lock-in an inflation-adjusted stream of income and who has an adequate number of other sources of liquidity.

*This is not a precisely apples-to-apples comparison and is not calculated using a technically correct method. It is shown in this way to illustrate the concept in an understandable manner.