

## “TIPS” for Playing the Inflation Game

With interest rates near record lows and commodity prices near record highs, it was only a matter of time before investor concern turned again to the monster of inflation. According to a survey by the University of Michigan, consumer prices are expected to jump 5.2% over the next 12 months.

Inflation destroys purchasing power. Regardless of whether the investor achieves stellar nominal returns, each US dollar today holds the same purchasing power as \$0.18 in 1970. The inflation process occurs slowly and often goes undetected over time.

The challenge for fixed-income investors: how to earn a steady return without letting higher prices erode purchasing power.

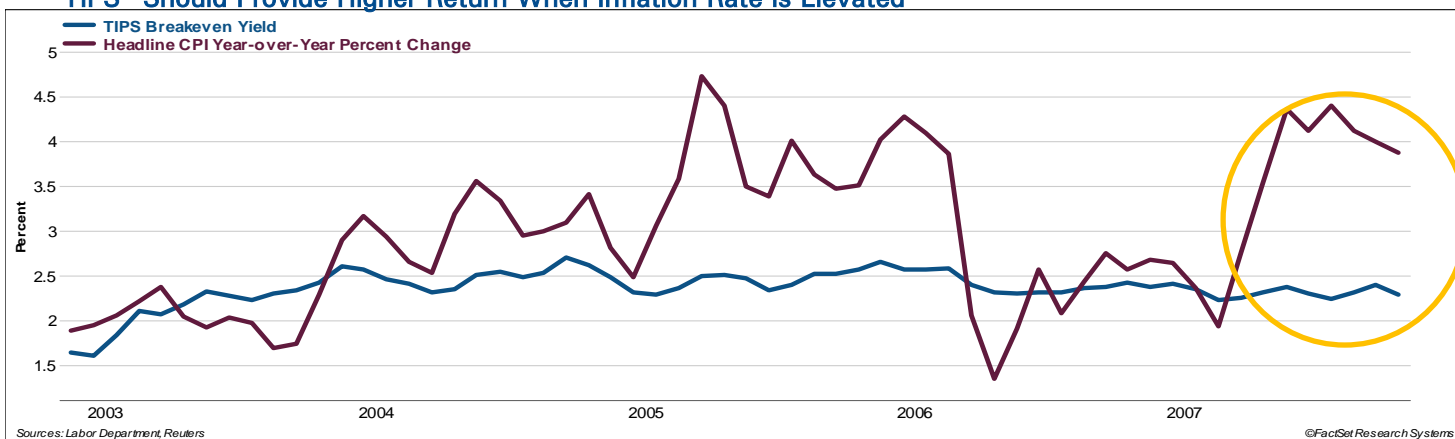
Often, gold (or commodities) and stocks are put forth as hedges against inflation risk. But with gold also near record highs and stocks volatile, a risk averse investor may be looking elsewhere for a safer alternative.

That’s where TIPS – Treasury Inflation Protected Securities – may become attractive pieces of your portfolio. Here’s why:

- Safety:** TIPS are direct obligations of the United States government and as such backed by the full faith and credit of the government. This makes TIPS **virtually default risk-free**.
- Principal Protected:** The principal amount is indexed to the Consumer Price Index. This guarantees that the “real purchasing power” of the **principal will keep pace with rising prices** through maturity of the bond. For example, if inflation runs at 5%, the original principal will increase from \$1,000 to \$1,050. While the coupon rate is fixed, the investor gains by virtue of having the principal escalated by CPI and achieves a “real” return.
- Interest Protected:** The investor receives semi-annual interest payments based on the coupon rate and principal indexed to the CPI. **This also guarantees a “real rate of return” above inflation over each semi-annual period.**
- Less Uncertainty/Volatility:** By removing “inflation-risk” from the list of investor worries, TIPS should be less volatile than nominal bonds in response to changes in inflation than otherwise.
- Lower Correlation to other Asset Classes:** Whereas returns on nominal bonds tend to move in the opposite direction of inflation, TIPS returns tend to be positively correlated with inflation. If consumer prices rise, so do TIPS returns. In fact, to the extent that the “breakeven yield” (the difference between a nominal 10-year Treasury bond yield and the TIPS yield) is *below* the CPI inflation rate, **TIPS may achieve a higher total return than nominal bonds (see chart below)**. This is because the inflation compensation exceeds the difference in yield.

Aside from tax considerations, the first major drawback of TIPS is market liquidity. Although the overall Treasury market is one of the deepest, most liquid markets in the world, fewer participants and less trading activity in the TIPS market limits liquidity. As a result, the bid-asked spreads in the secondary market may be wider, leading to higher transactions costs. As the market develops, liquidity will likely improve. Second, if TIPS are sold *prior* to maturity it is possible to incur negative real returns, due to deflation or changes in interest rates.

### “TIPS” Should Provide Higher Return When Inflation Rate is Elevated



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## Background

The Bernanke-led Federal Reserve pushed the federal funds rate to 2.0% in April—the same month the Labor Department reported the biggest jump in food prices in 18 years. Oil and gold prices hover near all-time record highs and television talking heads tout the perils of “Inflation Nation” – how should investors respond?