

With TIPS, the risk or reward of inflation is removed from the bond and assumed by the government. TIPS pay a real return and promise to compensate owners for any inflation.

Is it best to buy TIPS or regular government bonds? To answer that question you need to look at the market's implicit inflation expectation. If you think inflation will be lower than the market, the regular bonds will give you a higher real return. If you expect inflation to be higher, TIPS are a better deal.

So how do you determine the market's inflation expectation? Here's an example from earlier this week with numbers pulled from www.bloomberg.com/markets/rates. The U.S. ten-year note was yielding 4.5% and the ten-year TIPS 1.9%. This means the market's implicit inflation forecast is 2.6% (4.5 – 1.9). If inflation turns out to be 2.6%, both the note and TIPS will be equal investments.

What is your inflation forecast for the next ten years? Like most of us you probably have no clue. The market's expectation of 2.6% seems reasonable so I would not make a big bet either way. I would buy some TIPS as an insurance policy on inflation, but also keep some normal bonds in case inflation is lower than expected.

TIPS are a pretty cool product but annoying from a tax perspective. The TIPS principal amount is adjusted for inflation every six months and gains are taxable every year. Since TIPS also pay interest, which is taxed as ordinary income, TIPS are best held in the tax-qualified portion of your portfolio.

If you like the idea of TIPS, but do not want to deal with individual TIPS, there are TIPS index funds in the form of Exchange-Traded Funds (ETFs) and mutual funds.

In summary, investors should be aware of all the products which might help them in an inflationary environment. TIPS are an excellent product and should be seriously considered by investors interested in hedging their inflation risk. More information is available at the Treasury's web site and from your favorite broker or adviser.

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Inflation & TIPS
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Did the recent inflation reports give you a little scare, like they did me? The Consumer Price Index (CPI) rose 1.2% in September and 4.7% over the last 12 months. Energy prices accounted for 90% of the increase - not surprising given Hurricanes Katrina and Rita.

The only bright spot is higher energy costs do not appear to be pushing up prices in the general economy, at least not yet. This is a major concern of the Federal Reserve and investors should expect them to aggressively raise interest rates if inflation spreads beyond the energy sector.

Should long-term investors worry about inflation? I think so. It was only 25-30 years ago that inflation ravished the life styles of retirees living on fixed incomes.

Inflation erodes buying power and effectively causes a negative return on your portfolio. If your portfolio makes 5% and inflation is 2%, your real return is 3%. (Real return is used to describe numbers adjusted for inflation.) If inflation moved to 6% your return would be -1%. Who said you can't lose if you stand still?

There is no "cure-all" for inflation but investors should consider adding some Treasury Inflation Protected Securities (TIPS) to their portfolios.

In a nutshell, TIPS allow investors to invest in US government bonds without worrying about inflation. If there's any inflation, bond holders will get paid more and if prices fall, TIPS cannot go below their issue price. Pretty good, ah?

Figuring out if TIPS are a good investment is a little more complicated. Let's go back and look at the interest rate on regular US bonds. Theoretically this rate can be split in two; one part is the real return bondholders demand and the other is their inflation expectations. For instance, if the interest rate on a bond is 5% the bondholders might expect inflation of 3% which would end up giving them a real return of 2%. The key is bondholders take on the risk of inflation. If inflation is less than 3% they earn a higher real return and if inflation is higher, their real return falls.