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Looking the TIPS Market

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About a year ago I suggested that investors concerned about inflation should put some savings into Treasury Inflation Protected Securities (TIPS).

Since that time the overall TIPS market's performance can be considered fair, at best. If we use the iShares TIPS ETF, which invests in all outstanding TIPS securities that have at least one year until maturity as a proxy for the market, the total return has been 1.73 percent for the past year.

Looking at the Fund more closely we see that the price fell about 3.2 percent; while interest payments countered this fall by adding 4.93 percent; resulting in an overall return of 1.73 percent. For comparison, in the same period, a Vanguard bond fund which tracks regular US government bonds of similar maturities returned about 3.55 percent.

Let's briefly review TIPS before discussing today's market in more detail.

The U.S. Treasury started issuing TIPS in 1997 to create a way for investors to own government debt securities that would be protected from inflation. TIPS effectively remove the inflation risk by paying holders extra interest and/or principal to compensate for actual inflation.

While the interest rates on each bond never change, the bond's principal is adjusted based on the inflation rate. Therefore the dollar amount of each interest payment increases with inflation. At maturity, the holder receives either the bond's adjusted principal or the original principal, whichever is greater.

TIPS are adjusted for inflation using the Consumer Price Index-Urban, (CPI-U) which, unlike the core CPI, takes into account the volatile food and energy sectors. Over the past year though August the CPI-U is up 3.9 percent.

Let's look at a simplified example. Assume you bought \$1,000 of a two-year TIPS with an interest rate of 2 percent; paid annually (in reality interest is paid every six months).

If there is no inflation, after one year you would receive an interest payment equal to 2 percent of \$1,000, or \$20. At the end of the second year with no inflation you would receive another \$20 plus the principal of - \$1,000 for a total of \$1,020.

Now assume inflation was 10 percent the first year. In this case the principal of the bond would be adjusted 10 percent higher - from \$1,000 to \$1,100. The government would then pay 2 percent of the new principal of \$1,100 or \$22. You can see that although the interest rate did not change, both principal and payment rose by the inflation rate of 10 percent.

If inflation continued to increase at 10 percent in the second year, the principal would be adjusted to \$1,210 and the holder would receive 2 percent of \$1,210 or \$24.20. And since the bond is maturing, the holder would also receive the final principal amount - \$1,210.

Tax note: the changing principal is a pain in neck since it has to be recognized on your tax return every year and taxes need to be paid on the gain. For that reason and because all bond interest payments are taxed as ordinary income, TIPS and other bond investments are best held in an IRA or other tax-qualified account.

Now let's look at real market numbers and compare 10-year TIPS with regular bonds. The yield to maturity on TIPS is around 2.25 percent and a regular bond yields 4.60 percent. The 2.35 percentage point difference is considered the bond market's implicit inflation forecast.

The implicit inflation forecast represents the breakeven point to determine if the TIPS or a regular bond is a better investment. If inflation is less than 2.35 percent, the regular bonds will have the higher return; if inflation is over 2.35 percent, TIPS will have the superior return.

Going back to the relatively weak performance of the TIPS ETF compared to other Treasuries, most of the difference can be attributed to a changing inflation outlook, especially at the short end (under 5 years) of the curve. One year ago the market's implicit 5-year inflation forecast was 2.63 percent and has now fallen to 2.21 percent.

Are TIPS good investments now? For traders over the next couple of months or years, I am not sure. However for long-term investors and people living on a fixed income portfolio, I strongly recommend some allocation to TIPS. Yes, TIPS will under-perform Treasuries if inflation is less than 2.25 percent, but just in case inflation gets out of control TIPS are your only sure protection.

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