Treasury Inflation-Protected Securities (TIPS)

For many investors, inflation-protected bonds – specifically designed to protect against rising consumer prices – are an effective way to guard against inflation. Treasury Inflation-Protected Securities, known as TIPS, are one of the most attractive members of this asset class.

WHAT IS INFLATION AND WHY SHOULD I BE CONCERNED ABOUT IT?

Inflation is an increase in the price of goods and services and, in effect, shrinks the value of your money. The dollar you invest today will be less valuable tomorrow, posing a serious threat to investors. Inflation is particularly concerning for bondholders since it can erode the purchasing power of future interest and principal payments.

In the U.S., a widely accepted measurement of inflation is the Consumer Price Index (CPI). As the chart below shows, prices have risen steadily in the U.S. since the end of World War II, signaling a steady rise in inflation.

HOW DO TIPS WORK?

Treasury Inflation-Protected Securities, or TIPS, are inflation-protected bonds (IPBs) that are issued by the U.S. Treasury. Their face value is pegged to the CPI and adjusted in step with changes in the rate of inflation. The Treasury then pays interest on the adjusted face value of the bond, creating a gradually rising stream of interest payments as long as inflation continues to rise. At maturity, a TIPS investor will receive the original face value plus the sum of all the inflation adjustments since the bond was issued.

It works like this: Suppose you invest $1,000 in a new 10-year TIPS with a 2% coupon rate. If inflation is 3% over the next year, the face value will be changed to $1,030 and the annual interest payment would be $20.60, or 2% (the coupon rate) of the adjusted principal and so on. In a deflationary environment, the reverse would be true: the face value and interest payments would decrease, but still keep pace with the now lower cost of goods and services.

As a result, TIPS and other IPBs offer a “real” rate of return – the actual return of an investment after inflation is taken into account. A traditional bond, on the other hand, offers a “nominal” return. It maintains a fixed face value until maturity, with no adjustments for inflation. For example, if you’re receiving a 5% return on a traditional bond and inflation is rising at 3%, your “real” return is actually only 2%.

WHAT ARE SOME OTHER ADVANTAGES OF INVESTING IN TIPS?

- TIPS can potentially be an effective portfolio diversification tool. Because TIPS have a low correlation with other types of investments, they may reduce overall portfolio volatility.
- TIPS offer the government’s assurance that investors will never receive less than the original face value of the bond at maturity, even in the event of deflation during the life of the bond.

FIGURE 1: THE RISING COST OF A DOLLAR

Based on the CPI, what one dollar could buy in 1945 would cost $13.26 today.
Diversification does not ensure against loss. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed.

Inflation-linked bonds (ILBs) issued by a government are fixed income securities whose principal value is periodically adjusted according to the rate of inflation; ILBs decline in value when real interest rates rise. Treasury Inflation-Protected Securities (TIPS) are ILBs issued by the U.S. government. Portfolios that invest in such securities are not guaranteed and will fluctuate in value.

The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Bureau of Labor Statistics. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. It is not possible to invest directly in an unmanaged index.

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FIGURE 2: HOW TIPS CAN GROW IN VALUE
TIPS can help guard against inflation by adjusting their face value with changes in the rate of inflation. Interest is then paid on the adjusted face value of the bond.

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