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FEATURE ARTICLE

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TIPS as Fixed Income Investments

Overview: Many investors may be sensitive to the damaging effects inflation can have on the buying power of their portfolios. One way to address this concern is through Treasury inflation-protected securities (TIPS).

There is an old saying in the investment world that the only returns that matter are the ones investors can spend. Thus, investors should account for the effects inflation can have on their spending power. Inflation poses significant risks to investors over the long term as it may decrease their buying power. One way to account for the effects of inflation is through fixed income investments in Treasury inflation-protected securities (TIPS).

What Are TIPS?

Similar to nominal (non-inflation-adjusted) U.S. Treasury fixed income investments, TIPS are issued with fixed coupon rates and fixed maturity dates (such as five, 10 or 20 years). The key difference between TIPS and nominal bonds is that the coupon rate for TIPS is a guaranteed "real" (inflation-adjusted) return. The principal is adjusted for inflation before the interest payment is calculated.

With TIPS, the coupon payments and face value will maintain purchasing power until maturity. Rates for nominal Treasury fixed income investments are typically higher than the rate for TIPS with comparable maturities because they include a risk premium for future inflation. However, there is no guarantee the coupon payments will retain purchasing power.

How Do TIPS Work?

The principal value of TIPS is adjusted by the Treasury Department according to changes in the Consumer Price Index for All Urban Consumers (CPI-U). The semiannual interest payments vary because the fixed coupon rate is applied to the inflation-adjusted principal, as illustrated below:

Year	Inflation Rate (%)	Amount of Principal Adjustment ($)	Adjusted Principal Value ($)	Total Coupon Payment ($)
1	0	0.00	100,000.00	3,000.00
2	2	2,000.00	102,000.00	3,060.00
3	1	1,020.00	103,020.00	3,090.60
4	3	3,090.60	106,110.60	3,183.32
5	1	1,061.11	107,171.71	3,215.15

Note: Example assumes an individual TIPS with a $100,000 principal value and a 3 percent coupon rate.

Benefits of TIPS

- ▲ TIPS work well in diversifying portfolios due to their low correlation to stocks. For the period 1999–2008, the quarterly correlation of the Barclays Capital US TIPS Index to the S&P 500 Index was –0.21.
- ▲ When inflation is higher than expected, TIPS typically outperform nominal Treasuries.
- ▲ TIPS have no credit risk.
- ▲ TIPS have lower volatility than either nominal Treasuries or other investments considered to be hedges against inflation (such as commodities).

Drawbacks of TIPS

- ▲ Because nominal Treasuries entail additional risk, TIPS have lower expected returns than nominal Treasuries.
- ▲ TIPS are expected to underperform nominal Treasuries during periods when actual inflation is lower than expected inflation. TIPS would also underperform intermediate- and long-term Treasuries during periods of deflation.

Tax Implications

Like all securities issued by the Treasury Department, TIPS are exempt from most local and state taxes (with the most notable exemption being state estate or inheritance taxes). Interest paid on TIPS held outside of tax-deferred accounts is considered ordinary income for federal income tax purposes. Also, increases to the inflation-adjusted principal are considered taxable income in the year they occur, even though TIPS investors do not actually receive these gains until the fixed income investments mature. Because of this tax inefficiency, TIPS should generally be held in tax-deferred accounts unless the investor is in a low tax bracket.

Summary

TIPS have many positive features, which make them valuable fixed income instruments. They provide a guaranteed real rate of return and are good equity diversifiers due to their low correlation to stocks. Investors who are particularly sensitive to the effects of inflation should consider devoting at least some portion of their fixed income assets to TIPS.