



INVESTORS OVERLOOKING BENEFITS OF INFLATION-INDEXED TREASURY BONDS

As inflation creeps along at 30-year lows and talk of deflation is taken seriously, it's difficult to interest investors in inflation-indexed Treasury bonds and notes. Yet these securities often will outperform comparable regular securities, with less volatility, according to a recent article in the *Journal of Financial Planning*.

Inflation-indexed Treasury bonds and notes—also known as Treasury Inflation Protection Securities (TIPS)—were introduced in 1997. Like regular Treasury securities, they come in a range of denominations—a minimum of \$1,000 for noncompetitive bids, up to \$5 million—and a range of maturities. Yields are set at each three-month auction. They can be bought directly from the federal government, through a broker for a fee or through mutual funds that invest in TIPS.

TIPS differ from regular Treasury securities in that principal is adjusted twice a year based on changes in the Consumer Price Index. For example, say you buy a \$1,000 TIPS yielding 3.5 percent. If inflation rises two percent, the principal is adjusted upward to \$1,020, and the 3.5 percent coupon rate is then paid on the higher principal.

As you would expect, a regular Treasury security, or comparable corporate security, will pay a higher coupon rate. The difference between the two coupon rates—called the break-even inflation rate—reflects the market's estimate of the future inflation rate. It's this difference that is the key factor for investors weighing whether to buy TIPS or comparable securities.

An April 1999 study of TIPS in the *Journal of Financial Planning* examined the break-even factor and concluded that regular bonds will outperform TIPS only when realized inflation rate proves lower than estimated. For example, if the inflation rate is estimated to run 1.5 percent in the coming year, but it turns out to be only 1 percent, then investors won't do as well with TIPS as they would have with comparable regular bonds. When inflation increases at the rate expected, the real rate of return (inflation-adjusted) of TIPS and comparable bonds will be the same—though TIPS have the

added benefit that they are less volatile than conventional bonds. When inflation spikes higher than anticipated, then TIPS will outperform regular bonds.

Keep in mind that the difference between the current yields for non-indexed Treasuries and comparable inflation-indexed Treasuries is a reflection of *future* expectations for inflation. So far in 1999, the difference has been running around 2.6 percent (it varies with each auction, of course). That means, if you are weighing the purchase of a ten-year TIPS versus a non-indexed ten-year Treasury bond, it would make sense to buy the conventional bond only if you feel that inflation will average less than 2.6 percent over the next ten years (this assumes holding both bonds to maturity). While inflation has been low recently and many experts believe it will remain low over the next decade, TIPS proponents point out that, historically, inflation in the United States has run slightly over three percent over the past 75 years.

Another issue the *Journal* article addressed is investor concern about the taxation of TIPS and the after-tax real return on TIPS. Like conventional bonds, coupon payments for TIPS are subject to federal income tax, though not to state or local taxes. The exception is if the bonds are held inside tax-favored accounts such as an individual retirement account. To prevent an unfair tax advantage for TIPS versus conventional bonds, the IRS also taxes the unrealized gains due to inflation adjustments.

Thus, a \$20 increase in principal to adjust for inflation would be taxed at the taxpayer's ordinary tax rate assuming the gain was outside a tax-favored account. The *Journal* study noted that given a high enough inflation rate—a little over nine percent in the example the article used—taxes owed on the gain would exceed the after-tax coupon payment. Despite this drawback, the article found that TIPS would still outperform conventional bonds in a high inflation environment as long as the inflation increase at least matches the expected inflation increase.

For investors who want a fixed-income component added to their portfolio, especially inside a tax-deferred account, inflation-indexed Treasury securities deserve a second look.

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