



## Perspective on TIPS

The US Treasury has been issuing *Treasury Inflation-Protected Securities* ("TIPS") since January 1997. TIPS provide investors with an investment option that helps protect against the effects of inflation. Like all marketable US Treasury securities, TIPS are backed by the full faith and credit of the US Government. TIPS are available to individual and institutional investors alike.

Interest payments on TIPS are made semi-annually and are linked to the Consumer Price Index for Urban Consumers ("CPI"). If inflation occurs, the principal increases; if deflation occurs, the principal decreases. Thus, the underlying value of the principal grows (or declines) at the same rate that prices (as measured by CPI) change as the value of the principal of TIPS are adjusted semiannually for inflation. The interest rate is applied to the inflation-adjusted principal, *not the original face value*. So, if inflation occurs throughout the life of the security, every interest payment will be greater than the one before it. The converse is true, however, in the event of deflation. Upon maturity, Treasury will pay the greater of either the inflation-adjusted principal or the original face value.

The amount of each six-month interest payment is determined by multiplying the inflation-adjusted principal (regardless of whether it is greater or less than the original face value) by one-half the fixed annual interest rate. Just as other US Treasury notes and bonds earnings from TIPS are exempt from state and local income taxes but TIPS owners pay federal income tax on interest payments in the year they are received and on growth in principal in the year that it occurs.

The US Treasury has expanded the TIPS program by adding a five-year and 20-year security to the current 10-year. *The best way to buy TIPS is through the US Treasury, is to place a noncompetitive bid through the auction process.*

- ✓ To buy a TIPS, you place a bid in an auction.
- ✓ At the time you bid for a TIPS, you don't know what its interest rate will be. The interest rate is determined at the auction.
- ✓ The minimum purchase amount is \$1,000. Bids must be placed in multiples of \$1,000.
- ✓ Once you buy a TIPS, you can hold it until maturity or sell it; When a TIPS matures, it is redeemed.

A hypothetical example:

Suppose you have \$100,000 invested in a TIP that pays a 2% interest rate, so you're earning \$2,000 a year. If inflation rises 3%, so does your principal amount from \$100,000 to \$103,000. Now, even though the interest rate hasn't changed, you're earning more interest (\$2,060 a year or 2% of \$103,000). Lastly, TIPS may be best suited for tax-deferred accounts because the principal adjustments are considered income in the year they occur and are subject to Federal income taxes.

### Pitfalls?

If buying TIPS on the secondary market *the investor may be easily confused* by the price on a confirmation vis-à-vis their understanding of their prior expectations of the price. TIPS are calculated like a reverse GNMA pass-through ... simply, the calculation is a factor of the current market yield to maturity times the factor of CPI adjustment from its date of issue to the sale date. In other words the calculation is a factor X a factor (e.g., TIPS 3 3/8% due April 14, 2032 (CUSIP 912810FQ6) @ 2.30 YTM = 121.938966. But due to the CPI adjustment (the "Index Ratio") that factor is @ 1.06455% x 121.938966 = 129.710127 settlement price!). *Caveat emptor!*