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Inflation-Fighting TIPS

It's easy to see how inflation affects your daily life. Gas prices are higher. Electric bills are steeper. Wallets are thinner. But what inflation does to your investments isn't always as obvious. Let's say your money is earning 4% and inflation is running between 3% and 4% (its historical average). That means your so-called "real return"--the stated return minus inflation--is only 1% at best. After you subtract any account fees, taxes, and other expenses, you could actually end up with a negative number.

What can you do to keep from losing the race against inflation? One of the easiest ways is to buy investments that are designed to keep pace automatically.

Take stock of TIPS

Since the U.S. Treasury introduced them in 1997, Treasury Inflation-Protected Securities (TIPS) have become the most widely known example of what are generally referred to as "inflation-protected securities." TIPS are especially popular with long-term investors who want to preserve the purchasing power of their money over time. Many investors also like the security of knowing their investment is backed by the U.S. government.

Like other Treasury bonds or notes, TIPS are basically loans to the U.S. government. You receive interest payments every six months based on a fixed interest rate specified in advance. With most bonds, it's easy to know the exact amount of money you'll receive each year. You simply multiply the principal--the amount of your initial investment--by the interest rate.

TIPS work a little differently. Instead of guaranteeing how much you'll be paid in interest, an inflation-protected security guarantees that your real return will keep up with inflation. The interest rate stays fixed; what you won't know is the exact dollar amount of the payments you'll receive. If inflation goes up, your return will increase to match it. With TIPS, you're trading



off the certainty of knowing exactly how much you'll receive for the knowledge that, as long as you hold the bond until it matures, your investment will maintain its buying power.

How do TIPS work?

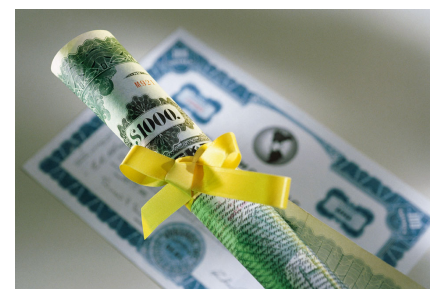
TIPS pay slightly lower interest rates than equivalent Treasury securities that don't adjust for inflation. The reason for that reduced rate? Your TIPS principal is automatically adjusted twice a year to match any increases or decreases in the Consumer Price Index (CPI), a widely used measure of inflation. If the CPI increases, the Treasury recalculates your principal to reflect the increase.

For example, let's say you buy \$20,000 worth of TIPS that pay a fixed interest rate of 2.5%. Over the next six months, the CPI rises at an annual rate of 3%. Your \$20,000 principal would go up by 1.5% (half of the 3% annual inflation rate) to \$20,300.

This adjustment will affect the amount of your semiannual interest payments. Even though the interest rate stays the same, it's applied to the recalculated amount of your principal. In this example, the 2.5% interest rate would be applied to the new \$20,300 figure. The actual dollar amount paid in interest goes up because it's based on a higher principal; instead of \$250, your next semiannual payment would be \$253.75. If inflation goes up again, your next payment will be higher still. (The return on a specific bond may be different, of course, since this is only a hypothetical illustration designed to show how the return on a TIPS is calculated.)

If the CPI figure is lower in six months, your principal will be adjusted accordingly when it's recalculated; that in turn will affect the amount of your next interest payment. If there's a period of deflation and the CPI is actually a negative number, your principal and interest payment would both drop.

The inflation adjustment feature means that if you hold a TIPS until it matures, your repaid principal will likely be higher than when you bought the bond. Even if the CPI turns negative and the economy experiences deflation, the amount you'll receive



when the bond matures will be the greater of the inflation-adjusted figure or the amount of your original investment.

Things to think about

You can still lose money with a TIPS if you don't hold it until it matures. Inflation rates rise and fall, and as with any bond, the returns offered by other investments can affect the market value of your TIPS. Also, if inflation turns out to be less over time than you had anticipated when you invested, the total return on a TIPS could actually be less than that of a comparable Treasury security without the inflation-adjustment feature.

Calculating the TIPS Advantage		
How do you know whether owning a TIPS makes sense? Subtract the TIPS interest rate from the rate for an equivalent bond without the inflation protection feature. If the inflation rate is higher than the difference between the two rates, the TIPS may have an advantage.		
If a TIPS pays...	And equivalent non-TIPS yield is...	Inflation rate needed for a TIPS advantage is...
2.5%	4.5%	More than 2%
3%	6%	More than 3%

If the inflation rate over time isn't high enough to make up for the difference between the lower interest rate of a TIPS and that of an investment without inflation protection, the TIPS has no advantage. That's why TIPS may only be appropriate for part of your bond holdings.

There's another catch. You'll also need to think about the federal taxes that will be due each year on the interest and any increases in your principal. Even though the Treasury records the changes in your principal every six months, you don't actually receive that money until the TIPS matures. However, the government still taxes that increase each year as if you've received the cash. Many investors prefer to postpone that tax bill by holding TIPS in a tax-deferred account such as an IRA.

How can I buy TIPS?

You can buy TIPS individually, in \$1,000 increments and with maturities of 5, 10, or 20 years. You could choose a selection of TIPS that mature at different times. When the shorter-term bonds mature, you could reinvest that principal into either another TIPS or some other type of bond. Known as "laddering," this strategy gives you flexibility as interest rates change. If interest rates are higher than the bond that's maturing, you can invest at a higher rate; if rates are lower, you might prefer an investment that offers a higher return. Also, if you will need some of your principal for a specific goal, such as college tuition, you can select maturity dates that return your principal at the right time.

Another possibility is a mutual fund, which may invest in TIPS only or mix them with inflation-protected securities from other entities, such as foreign governments. Typically, a fund invests in a variety of debt instruments to balance the higher interest rates usually offered by longer-term bonds with the flexibility of shorter maturities. A TIPS mutual fund pays out not only the interest but also any annual inflation adjustments, which are taxed as short-term capital gains. Some exchange traded funds (ETFs) also invest in an index composed of TIPS with various maturities.

Your financial professional can help you decide which choices may be appropriate as you race to keep up with rising costs.



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