Arcataur Capital Management LLC
826 N. Plankinton,
Suite 300
Milwaukee, WI 53203
414.225.8200

ARCATAUR CAPITAL

Arcataur Capital Management LLC
A Registered Investment Advisor

High Quality Investment Management
For Individuals and Institutions

# Treasury Inflation Protected Securities - TIPS

In 1997, the U.S. Treasury introduced Treasury Inflation-Protected Securities, (TIPS). A U.S. Treasury inflation-protected security is an investment that provides the security, growth and convenience of a U.S. Treasury security, while adjusting the principal to keep pace with inflation. Using changes in the Consumer Price Index (CPI) as a proxy for inflation, the principal value of the bond is increased by positive changes in the CPI. A fixed interest rate is paid semi-annually on the adjusted amount. At maturity, if inflation has increased the value of the principal, the investor receives the higher value. If deflation has decreased the value, the investor still receives the original face amount of the security. Because of the built-in inflation protection, these securities usually offer lower coupon rates than nominal Treasuries of similar maturities without the feature. TIPS are designed to protect investors against the effects of inflation, which can be one of the most damaging influences on a fixed income portfolio and also is one of the most difficult to hedge. According to Ibbotson Associates, inflation in the United States for the 85 year period between 1926-2011 has averaged 3.1% annually.

**How do TIPS work?** Let's consider an example. Assume you invested $10,000 in a new TIP issued in January 20X4. Similar to a traditional U.S. Treasury bond, TIPS carry a coupon rate and interest is paid semi-annually. In our example, let's say that the TIPS issued in January has a coupon rate of 2.00%. Most often, the coupon on a TIPS is less than a comparable Treasury due to the inflation adjustment feature. At mid-year, the Consumer Price Index indicates that inflation has been 1.5% during the first half of the year. Your principal balance is adjusted upward by $150 to reflect inflation ($10,000 x 1.5% = $150). Your interest payment (1/2 of 2.00% paid semi-annually) is based on the inflation adjusted amount ($10,150 x 1.0% = $101.50). At the end of the year, the CPI index reveals that inflation has been 3.5% for the year. Again, your principal is adjusted for inflation. In this case, the adjustment is 2.0% as you already received the first 1.5% mid year. Your principal balance is $10,350 and your interest payment is $103.50. The principal amount is adjusted for inflation, but the inflation adjustment is not paid until maturity.

**What are the benefits of owning TIPS?** TIPS offer a number of potential benefits to investors.

- TIPS are direct obligations of the U.S. government and are backed by the full faith and credit of the federal government, and therefore they represent high credit quality.
- TIPS' principal is protected against inflation. Since the principal is indexed to the CPI and grows with inflation, the investor is guaranteed that the real purchasing power of the principal will keep pace with the rate of inflation.
- Interest paid on the TIPS also is protected from inflation. The investor will receive semi-annual interest payments, based on a fixed semi-annual interest rate applied to the inflation-adjusted principal, so that the investor is guaranteed a real rate of return above inflation.

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## What are the drawbacks of owning TIPS?

- The current interest rate paid by these securities is lower than similar Treasury securities without the inflation protection. An investor also is liable for federal taxes on the inflation adjustment unless they are used in a tax-deferred or non-taxable account.
- TIPS are not as easy to trade on the open market as non-indexed Treasuries.
- Lastly, if the United States economy suffered from deflationary influence, then TIPS could provide a slight drag on performance on a bond portfolio.

**In Summary -** does it make sense to include TIPS as part of your diversified bond portfolio?

Managing the effects of inflation on your portfolio with creditworthy, inflation-indexed securities can be an important step toward managing your overall assets. They provide the following general elements to improve diversification and balance to a fixed income and total investment portfolio.

- The interest rate (coupon) is set at issue and does not change over the life of the security.
- The principal amount is adjusted for inflation, but the inflation adjustment is not paid until maturity. In a non-taxable account such as an IRA, there are no tax consequences. In a taxable account, interest payments as well as the inflation adjustment represent ordinary income. Taxes must be paid annually on both although the only payment the investor receives is the interest component. **Arcataur typically invests in TIPS in tax deferred or non-taxable accounts for clients to minimize this impact.**
- Historically, TIPS have been less liquid than a traditional U.S. Treasury bond as the amount of TIPS issued is small relative to the overall issuance of U.S. Treasury bonds. However, the U.S. Government continues to issue new TIPS. This has significantly increased the liquidity in the market. Presently, TIPS are nearly as liquid as traditional Treasuries. There is an active secondary market that allows for purchase or sale of nearly any TIPS currently issued. **Arcataur also utilizes TIP ETFs to augment direct TIP investments in client fixed income portfolios.**



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