



## BOND CONCEPTS

# Understanding Treasury Inflation-Protected Securities (TIPS)

Inflation is the pace at which prices increase throughout the U.S. economy, as measured by the Consumer Price Index (CPI). Inflation becomes a problem when there isn't a corresponding increase in real wages to counteract the negative impact of rising prices. For years after the 2008 Financial Crisis, inflation was not a primary concern for investors, but the recent resurgence has renewed interest in protection strategies. Treasury Inflation-Protected Securities (TIPS) may offer a solution.

## What are Treasury Inflation-Protected Securities (TIPS)?

Treasury Inflation-Protected Securities (TIPS) are bonds issued by the U.S. government whose primary feature is an adjustable principal that offers a degree of insulation from the effects of inflation. As inflation (the Consumer Price Index) rises, the principal amount or value of the bond rises in tandem. The interest rate is then applied to the new principal amount, and the investor receives higher interest payments. Conversely, investors will receive lower interest payments if deflation occurs.

TIPS are issued with maturities of 5, 10, and 30 years and are considered a low-risk investment because they are backed by the U.S. government. At maturity, TIPS return the adjusted principal or the original principal, whichever is greater.

## TIPS' Price Relationship to Inflation

Traditional bonds face inflation risk because the interest rate paid is fixed until maturity. As a result, the bond's interest payments might not keep up with inflation. For example, if prices rise by 3% and an investor's bond pays 2%, the investor has a net loss in real terms.

TIPS are designed to protect investors from the adverse effects of rising prices over the life of the bond.

While deflation can reduce interim interest payments, investors who hold TIPS to maturity are guaranteed to receive the original principal. However, selling before maturity in the secondary market may result in receiving less than the initial investment.

## Advantages

- **Inflation protection:** Both the TIPS principal and interest payments rise with inflation, as interest is calculated on the adjusted principal balance.
- **Principal security:** At maturity, investors receive either their original principal or the higher inflation-adjusted amount, ensuring no loss of principal.
- **Low risk:** Backed by the U.S. government, TIPS are considered nearly risk-free investments.

## Disadvantages

- The inflation adjustments to the principal are taxable in the year in which they occur, even though the inflation adjustments will not be paid until maturity.
- TIPS usually pay lower interest rates than other government or corporate securities, so they are not necessarily optimal for income investors.
- If inflation is minimal or nonexistent while TIPS are held, their utility decreases.



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The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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