

Treasury Inflation-Protection Securities

WHAT ARE TIPS?

On January 29, 1997, the Treasury Department issued the first U.S. security indexed to the rate of inflation. Called Treasury Inflation-Protection Securities (TIPS), these bonds provide protection from inflation by guaranteeing investors a certain “real” return. A real return is the stated, or nominal, return less the rate of inflation. Specifically, it is the nominal return less inflation as measured by the Consumer Price Index, or CPI. Thus, TIPS provide a guaranteed hedge against the loss of purchasing power that accompanies increases in the CPI. Because of the built-in inflation protection, these securities usually offer lower coupon rates than Treasuries of similar maturities without the feature.

HOW DO TIPS WORK?

In terms of mechanics, the TIPS issue increases its principal by changes in the CPI every day. Every six months, the interest payment — which is calculated on the inflated principal — is issued. A TIPS principal grows at the same rate as inflation, maintaining its real value, and is repaid at maturity.

TIPS are different from a conventional bond, in that the interest paid on the latter is paid on a fixed principal amount, which is repaid at maturity. Inflation is a major risk to a conventional bondholder, since increasing inflation means lower real income (interest payments) in the face of higher prices.

Here’s an example of how inflation-indexed securities work: Let’s say you invest \$1,000 in January in a new 10-year inflation-indexed note paying 3% interest. At mid-year, the Consumer Price Index indicates that inflation has been 1% during the first six months. Your principal is adjusted upward to \$1,010, and your interest payment (one-half of 3%) is based on that figure. Your payment will be \$15.15. At the end of the year, the index indicates that inflation was 3%, which brings the value of your principal to \$1,030. Your second interest payment will be \$15.45 (\$1,030 multiplied by 3%, and divided by 2).

WHY ARE TIPS IMPORTANT?

TIPS are important to investors because they are the first instruments to provide an efficient hedge against inflation. During periods of high inflation, bondholders and stockholders are hurt from the decline in the purchasing power of their investments. Besides their inflation-hedging properties, TIPS are backed by the full faith and credit of the U.S. Government and, thus, have no credit risk.

The inclusion of TIPS into a portfolio can provide diversification benefits. They also provide insurance against unexpected inflation, which is what most inflation is. When inflation is less than the market anticipates over the holding period, TIPS will most likely underperform a conventional Treasury bond. Alternately, during a period of high, especially unexpected, inflation, TIPS generally outperform conventional Treasury bonds.



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WHAT ARE THE RISKS?

There are considerations to be addressed before investing. First of all, the TIPS market has only been around for a little over 10 years with 24 issues currently outstanding. The TIPS market is \$150 billion in size, or 4.5% of the Treasury market.

As mentioned above, there is also the risk that inflation will be less than expected in the market. In addition, TIPS may not provide adequate inflation protection if the savings goal you are planning for grows at a faster rate than the general rate of inflation. For example, if you are saving for your child's college, and the price of tuition is growing at a faster rate than the overall rate of inflation, a TIPS investment would not provide adequate inflation protection.

WHAT IS THE TAX TREATMENT?

TIPS are designed for use in tax-advantaged accounts (e.g., IRAs). This is because you must pay income tax each year on the annual interest payments as well as on the inflation adjustment. This is particularly arduous because you won't receive the inflation adjustment until the security matures. As such, you'd be paying income tax on money you will not receive for many years in the future. Prior to purchasing TIPS, please consult a tax advisor for further information about the specifics of investing in this security.

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