

Q & A: Inflation-indexed Treasury securities

Inflation-indexed Treasury securities (commonly referred to as TIPS) first were introduced in 1997. They were created to protect the purchasing power of “savers” and bond investors, while earning a guaranteed rate of return on their principal.

What are TIPS?

TIPS are one of two types of inflation-protected securities sold by the U.S. Treasury. The other type is the Series I savings bond. (This article discusses only TIPS.)

Although popularly referred to as bonds, inflation-indexed securities actually are either five-, ten- or 20-year Treasury notes. Five-year TIPS are auctioned in April and October; ten-year in January, April, July and October; 20-year in January and July. They pay interest every six months, based upon a fixed rate applied to an adjusted principal. Specifically, each interest payment is calculated by multiplying the adjusted principal by one-half of the interest rate.

As is the case with all public debt instruments issued by Uncle Sam, TIPS are backed by the “full faith and credit” of the federal government. Because of this inflation protection, the fixed rates offered by TIPS tend to be a little lower than those offered on regular bonds or notes.

What else do I need to know?

Principal rises with inflation as measured by the Consumer Price Index, so each interest payment is likely to be larger than the previous one. The idea is that when the bond reaches maturity, investors receive back dollars that can purchase as much as the money that was invested. Thus, TIPS provide full protection for those investors worried about future inflation.

Example: Suppose that Investor purchases a \$1,000 inflation-indexed bond yielding 3%. If the 2006 inflation rate is 3%, next year the principal value of Investor’s bond increases by 3%, to \$1,030. Interest then will be figured on that higher value. Thus, instead of receiving \$30 in interest for the second year, Investor receives \$30.90.

When TIPS mature, the Treasury Department redeems them at their inflation-adjusted value or at par (face value at the original issue date), whichever amount is greater. Principal of marketable TIPS cannot drop below par, so there is some degree of protection. TIPS may be sold in the secondary (resale) market.

What are the tax consequences of TIP investments?

Although TIPS are exempt from local and state taxes, the interest paid (that is held outside of a tax-deferred account) is ordinary income and subject to federal income tax. Each payment of interest *as well as the increase in value of principal* must be included as income on an investor's income tax return.

What's important to keep in mind here is that the tax generated by the increase in value in principal must be paid, even though the increased principal has not actually been received by the investor. Should inflation balloon significantly, it's conceivable that an investor could owe Uncle Sam more in annual tax than he or she actually receives in interest.

Conservative investors may well find attractive the inflation protection offered by TIPS. And as investments for 401(k) plans and IRAs, inflation-indexed bonds may make sense because current tax on interest and the increase in principal can be avoided.

Are inflation-indexed bonds right for your portfolio? Take the first step by speaking with a professional who can evaluate your needs, review your current holdings and then make recommendations that make sense in your particular circumstances.

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