THE WALL STREET JOURNAL.
WSJ.com

UPSIDE | February 1, 2013, 5:18 p.m. ET

BY BRETT ARENDS

Looking for Inflation Protection? Take TIPS off Your List

By BRETT ARENDS

Would you buy an investment that was guaranteed to lose money?

That is the situation investors are embracing today in the market for Treasury inflation-protected securities, or TIPS—bonds issued by the U.S. Treasury whose value is designed to keep up with consumer prices.

The effective interest rates on TIPS have collapsed to record lows. It is mathematically impossible now for investors to earn respectable returns from any of them, and in many cases they are a lock to lose money in real, inflation-adjusted terms.

This doesn't mean you should dump all of your TIPS at once. But by selling long-term TIPS and holding only short-term ones, you can lock in your biggest gains today and reduce the odds that you will be stuck holding money-losing investments years from now.

TIPS, which have existed since 1997, are a fine idea on paper. The principal adjusts twice-yearly to take account of changes in the consumer-price index. So for the life of the bond, the investor is guaranteed that his investment will keep up with inflation and earn an additional interest rate, known as the "real return."

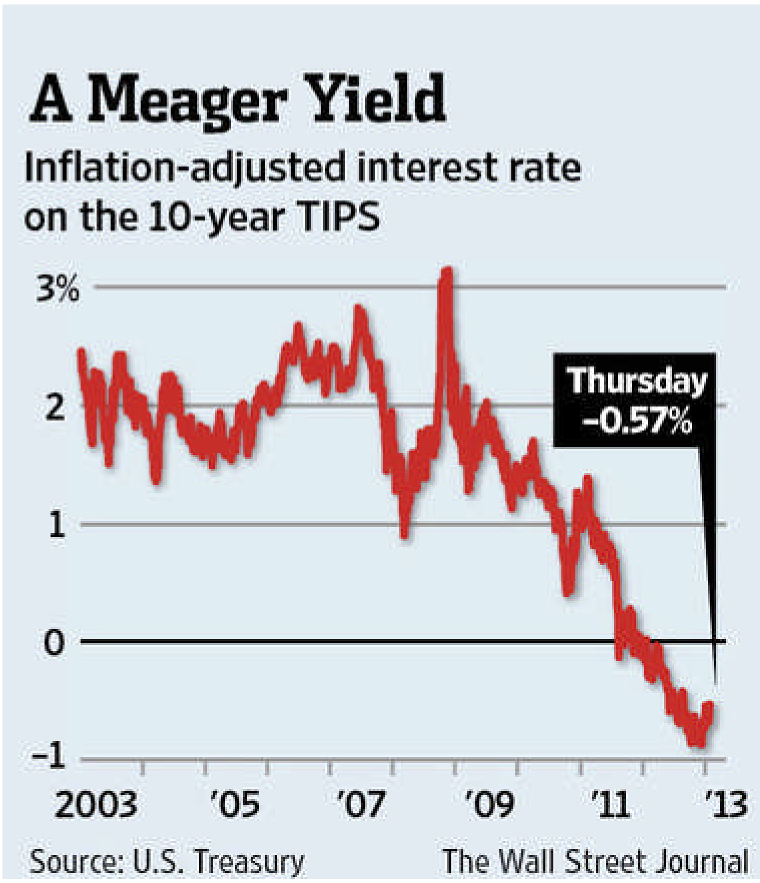
Associated Press

Federal Reserve Chairman Ben Bernanke.

Typically, say analysts, these bonds have usually been considered good value when they have offered a real return of 2% or more a year. That has approximated the average historical return, after inflation, of regular bonds.

Yet today's TIPS yield a fraction of that.

The 30-year TIPS today offers a real return of inflation plus 0.5% a year. For TIPS coming due within the next 10 years, the real return is negative: Your investment is guaranteed to leave you poorer, in real terms, than you are now. A five-year TIPS today locks in an interest rate of inflation minus 1.4% a year. Over the life of the bond, investors will lose 7% in real terms.



Paul Winter, a 20-year veteran of the bond market now working as a fee-only financial adviser in Salt Lake City with $30 million under management, considers all TIPS a poor investment.

Yet they remain popular. FRC, a Boston firm that tracks the mutual-fund industry, says U.S. investors own at least $145 billion worth of TIPS through funds that specialize in them. The amount of TIPS in circulation has risen 50% in five years to $850 billion, according to the U.S. Treasury.

Investors have been buying TIPS in recent years for two reasons, say analysts. Some are looking for a better alternative for their short-term money than cash, which is earning almost 0%—and less than inflation. Others are looking for long-term protection against the risk of surging inflation.

Investors seeking short-term alternatives to cash should stick to short-term TIPS, preferably those that mature within five years.

The Federal Reserve, trying to kick-start the economy, is keeping short-term interest rates at zero and is taking action to drive down long-term rates as well. For savers, this means regular bank deposits, money-market funds and short-term Treasurys effectively lose them money each year. Short-term TIPS, while ugly, might be less so than the alternatives.

There is an argument for using TIPS as a safe-haven alternative to Treasurys. "If I buy nominal Treasurys right now, I can basically earn 0% in a 3%-inflation environment, so I'm losing 3% in real terms per year," says Carl Friedrich, chief investment officer at Piermont Wealth Management in Woodbury, N.Y., which has $130 million under management.

By comparison, he says, some TIPS don't look so bad.

Investors seeking longer-term protection against inflation should also stick with short-term TIPS. Even though long-term TIPS might offer higher real rates of return, they are much more volatile, Mr. Friedrich says. If interest rates rise across the economy, he says, those longer-term bonds could fall sharply in price.

"If you're going to take a position in TIPS," Mr. Friedrich says, "keep the maturity at the short end, ideally no more than five years."

Logically, owning long-term TIPS will probably work out well only if the economy plunges into a multidecade deep freeze or bursts into rampant runaway inflation. In either scenario, one can expect plenty of volatility ahead—and many opportunities to earn better rates of return than half a percent a year.

The smart move now is to cash in gains on long-term TIPS.

Bonds are like seesaws: The yield falls as the price rises. TIPS yields have collapsed as their price has risen. The longest-term bonds, which are the most volatile, have risen the most. The February 2040 TIPS has risen 40% in price since it was issued three years ago. Investors are sitting on some hefty capital gains.

So it makes sense to cash those in. As an added bonus, the gains, assuming the bonds have been held for more than a year, will be taxed at a maximum rate of 23.8%. The annual income from the bonds, if held, will be taxed higher as ordinary income.

Investors still looking for long-term protection against the risks of high inflation in the future might find better value in real estate, such as in investment properties, and in commodities, both of which look cheap compared with their long-term averages.

In commodities, experts suggest investments such as the iPath Dow Jones-UBS Commodity Index Total Return exchange-traded note, a contract issued by Barclays that tracks an index of commodities. It carries an annual fee of 0.75%.

Write to Brett Arends at brett.arends@wsj.com

A version of this article appeared February 1, 2013, on page B7 in the U.S. edition of The Wall Street Journal, with the headline: Looking for Inflation Protection? Take TIPS off Your List.