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TIPS Down, but Not Out

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Investors who tried to find sanctuary from portfolio-rotting inflation via the TIP exchange-traded fund may be wondering why their fund is falling while inflation keeps rising.

The **iShares Lehman TIPS Bond** (TIP:NYSE) , which invests solely in Treasury Inflation Protected Securities (TIPS), is down 1.99% so far this year, providing little comfort to those who believed they'd be "protected" as the fund's name suggests.

The downturn comes as rising interest rates create volatility for the TIP ETF's short-term investors. Longer-term holders, however, still may be poised to benefit as rate changes smooth out.

As a whole, the TIPS situation may not be as bad as it appears on the surface, says Matt Tucker, head of product strategy for fixed income at Barclays Global Investors, the firm that birthed the TIP ETF.

This year, the yield on 10-year TIPS has risen to 2.51% from 2.05%, cutting the market value by about 4%. Tucker notes, though, that there are mitigating factors to the bond's faltering prices.

"That's just the price component; there is also the income piece," he says. "There is also the coupon, and investors will also receive an adjustment to principal amount based on changes in inflation."

In addition to a nominal or fixed coupon payment, holders of TIPS also receive extra interest payments that grow in lockstep with changes in the consumer price index. And on top of that, the principal or face value of the bond is increased in line with inflation.

The relationship to the CPI is why some investors with long-term-focused portfolios buy TIPS-type funds as a hedge against the withering effects of a rising price level. It gives investors the security of knowing that at least a portion of their portfolio will keep pace with inflation.

The pain for inflation-fighting fund holders, however, may continue further if the **Fed** keeps raising short-term rates. The TIPS market, as a whole, is extremely sensitive to changes in interest rates relative to its sensitivity to changes in inflation, says Ken Volpert, senior portfolio manager of Vanguard Inflation-Protected Securities, a mutual fund that invests in TIPS.

Changes in interest rates have eight times more negative impact on the price of the inflation-protected bond than equivalent changes in inflation, he explains. For example, a one percentage point increase in interest rates would lead to an 8% drop in the price of a TIP, while a 1% jump in inflation would result only in a 1% increase in the principal value of the TIPS bond.

"The most important thing for investors to understand about TIPS and TIPS funds is that they're not immune to price volatility," says Eric Jacobson, senior analyst at Morningstar. Over time, he notes, the growth in the value of TIPS funds will converge with that of the CPI, but in the short term, investor demand and interest rates play a factor.

Specialty mutual funds that invest in TIPS have seen the value of their investments retreat by an average of 2.14% this year, according to data from mutual fund watchdog Morningstar, with the worst, the Wells Fargo Advantage Inflation Protection Bond fund, down 2.9%.

"All the major economies are tightening, and there are a lot of negatives that require real interest rates to go up," says Volpert. "The best environment [for TIPS] would be when real interest rates are declining."

Along those lines, investors holding on to TIPS funds for the long term could likely see their losses reverse when the Fed eventually lowers interest rates.

"For the vast majority of clients, their time horizons are measured in five- to 10-year increments," says Paul Winter, head of Five Seasons Financial Planning in Salt Lake City. "When someone complains [about performance] , we always go back to basics," and discuss personal goals such as when the client will need to cash out his investment.

Winter is a fan of the Vanguard fund because the fund has a particularly low expense ratio of 0.2%. The average inflation-protected bond fund has an expense ratio of around 1.0%. Like the Vanguard fund, the iShares TIPS ETF also has an expense ratio of 0.2%.

Winter also likes Treasury Direct as a way for individuals to get such exposure to the investment class. Treasury Direct allows investors to purchase U.S. bonds, including TIPS, straight from the U.S. Treasury, and eliminate any third parties and the fund expenses. Such transactions can be executed over the Internet.