

## TIPS yields go negative

But advisers still recommend the securities as an inflation hedge

By David Hoffman | March 17, 2008

Driven by inflation fears, TIPS yields, which are traditionally lower than Treasury yields, have recently dipped below the horizon, but they are still the best game in town for hedging against inflation, according to financial advisers. The fear is driving up the price of Treasury inflation protected securities, which are identical to Treasury bonds except that principal and coupon payments are adjusted to eliminate the effects of inflation.

For the first time since TIPS began trading in 1997, the yield on the 5-year TIPS note ended Feb. 29 at -0.043% and has remained negative ever since, according to data from Bloomberg LP of New York.

The yield on TIPS with longer maturities also has come down but has not dipped into negative territory. For example, 10-year TIPS started the year at 1.59% and were trading March 12 at 0.84%.

As a result, investors are paying more for the principal protection offered by TIPS.

"Unfortunately, TIPS are costing you a bit," but in an inflationary environment, investors who haven't already considered TIPS should think about them, said Rick Miller, a financial planner with Sensible Financial Planning and Management LLC, a Cambridge, Mass.-based firm with \$155 million in assets.

"I would say for people looking for principal protection, this is the best place to go," he said.

Investors who got into TIPS early have certainly been rewarded.

The inflation-protected-bond-fund category had gained 6.14% year-to-date and 14.6% for the one-year period as of March 12, according to Morningstar Inc. of Chicago.

The Lehman Brothers U.S. Aggregate Bond Index was up 1.33% and 6.65%, respectively, for those periods.

The Standard & Poor's 500 stock index, meanwhile, was down 10.45% and 5.11%, respectively.

Despite the recent dip in yields, the strong run in TIPS still has legs, according to Seth Plunkett, Mountain View, Calif.-based co-manager of the \$97 million American Century Inflation-Adjusted Bond Fund.

The fund is advised by American Century Investment Management Inc. of Kansas City, Mo.

It's widely believed that the Federal Reserve Board will continue to lower the federal funds rate as it attempts to keep the economy going and that that will lead to a weaker dollar and more inflation, Mr. Plunkett said. In such an environment, "there's no reason TIPS shouldn't continue to perform," he said.

Financial advisers largely agree.

Negative yields shouldn't concern investors, because they should not be buying TIPS for yield in the first place, said Scott P. Snow, managing director and principal of Scott Snow Financial Advisors LLC, a Westlake, Ohio, firm with \$250 million in assets.

With so much fear about inflation, "we're pretty big on TIPS, even with a negative yield," he said.

TIPS are expensive, but for a retired investor looking for a conservative investment who doesn't already own them, making small incremental investments in TIPS still makes sense, said Mark Balasa, co-president of Balasa Dinverno & Foltz LLC, an Itasca, Ill.-based firm with \$1.5 billion under management.

For example, if an investor wants a 10% exposure to TIPS, one strategy would be to do 2% now, 2% in a couple of weeks and so on, he said.

Because TIPS are so pricey, however, Mr. Balasa does not recommend that investors load up on TIPS if they already have a sizable TIPS position.

TIPS haven't reached the point where investors who hold them should contemplate selling, said Richard Schroeder, executive vice president of Schroeder Braxton & Vogt Inc., an Amherst, N.Y., financial advisory firm with \$220 million in assets.

But he said that now may not be the right time to buy TIPS. Mr. Schroeder thinks municipal bonds are attractive.

Muni bonds, which are issued by governments to fund projects, typically have been a safe haven for investors. But recently, investors have begun to question the quality

of insured muni bonds because of problems faced by muni bond insurers related to the subprime-mortgage crisis.

As a result, muni prices have come down and yields have gone up, Mr. Schroeder said. Muni yields have actually been trading at premiums to Treasury yields — an uncommon event.

It's created a buying opportunity because despite the market's reaction, munis are still relatively safe investments, Mr. Schroeder said.

"Anyone that has taxing authority is not going to default," he said.

Of course, muni bonds without inflation protection are subject to the negative effects of inflation.

TIPS are the best investment to use when trying to blunt the effects of inflation, but there are other methods, said J. Michael Martin, president at Financial Advantage Inc., a Columbia, Md.-based firm with \$260 million in assets.

Although not inherently a hedge against inflation, gold can act as a hedge, he said.

Inverse funds, which seek to move in the opposite direction of an index, are another "arrow in the quiver" to minimize the effects of inflation, Mr. Martin said.

He conceded that inverse funds can be tricky to use. And gold investments, like TIPS, have gotten expensive, Mr. Martin said. Gold has gotten so expensive, he said, that he recently cut back his holding in the \$20 billion StreetTracks Gold Shares ETF, from State Street Global Advisors of Boston, in order to bank gains.

Investors worried about inflation, however, needn't turn to such exotic investments, argued Patrick Hanratty, a managing director with Capital Advisors Ltd., a Shaker Heights, Ohio-based firm with \$450 million under management.

In fact, they don't need to turn to TIPS, he said.

The best hedge against inflation is equities, Mr. Hanratty said. "That's what equities are for," he said. "That's your hedge against inflation." And unlike TIPS, it's not hard to find cheap stocks, Mr. Hanratty said.