TIPS Bonds and I Bonds

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In times of unknown predictions, presidential races, terrorist threats, and the uncertainty of the future, most people are certain that the cost of almost everything is going up. Inflation has been with us for almost as long as the bureau of labor statistics has been measuring it. For example, the U.S. Department of Labor, Bureau of Labor Statistics, has listed in its consumer price index that in July 2004 the consumer price index is 189.4 percent of what the same costs were in 1984, an average rate of 9.47 percent per year for 20 years (**ftp://ftp.bls.gov/pub/special. requests/cpi/cpiai.txt**). Yet, current inflation is projected at approximately 3 percent (**www.inflationdata.com**). In the same time, bond ladders with bond maturities no greater than 10 years have yielded an average rate of return of 7.6 percent according to Crestmont Research (**www.Crestmont Research.com**). Yet, current yield on Treasury Inflation Protected Securities, TIPS, recently yielded 2 percent for the 10 year issue. Our times are very unusual and puzzling for many, even the financial gurus who provide us opinions that the markets could move in either direction. Yet inflation is still here, so it is appropriate to discuss investment strategies that automatically adjust for inflation. This article will discuss the benefits and detriments of inflated adjusted savings bonds, I Bonds, and TIPS.

What Is a TIPS Bond?

A TIPS, or Treasury Inflation-Protected Security, is a particular type of marketable Treasury security: a bond. A TIPS bond pays interest semiannually, every six months, and principal at its maturity. The key difference between a TIPS bond and a regular U.S. Treasury bond is that the interest and maturity value are tied to inflation. The amount of interest earned and the face value of the bond will change.

Even though the bond has a fixed interest rate at the time of purchase, interest is paid semiannually based on the adjusted face value of the bond. The face value of the bond is adjusted based on the Consumer Price Index. As the face value increases, due to inflation, a bond holder is paid more interest, as more face value, or principal of the bond, is owed at maturity. If, however, deflation were to occur, a built-in safeguard does not allow the principal value to fall below the bond's initial face value. If deflation were to occur, then the interest payment would decrease, as less face value or principal is due; hence, less interest would be due.

TIPS can be ordered directly from the government, online, or, if one seeks professional management of a TIPS fund, many of the large mutual fund houses offer them. Check out Vanguard, Pimco, and Fidelity.

What Is the Problem with TIPS?

If you do not hold a TIPS in a retirement fund, you may have "phantom" income. Phantom income occurs when the inflation adjustment increases the amount of principal you are owed. This increase in maturity value, principal, is considered current taxable income, even though you do not receive the principal increase until maturity. (Ouch!) That is why retirement plans are suggested by many to hold these bonds. On the other hand, like most U.S. Treasury obligations, TIPS interest income is exempt from state and local taxes for those of you in high tax states and counties!

Even though inflation protection exists, interest rate protection does not.

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Inflation and market risks are here to stay.

That is why TIPS could be an important component of a bond ladder, 10-year ladder or less, but should not constitute an entire bond portfolio as it would not protect an investor from rising interest rates, and lost investment opportunity. But at least you know your rate of return will always beat the inflation rate!

I Bonds

I Bonds have many features similar to TIPS, and some distinctions. I bonds are 30-year U.S. savings bonds that are adjusted semiannually for inflation. They are offered in denominations of $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000. As a U.S. savings bond, income taxes on I Bonds earnings, principal, and interest, may be deferred until maturity, in which case all income tax is due at maturity. Conversely, the income may be reported annually, in which case taxation is due annually. Interest income on I Bonds are NOT paid until maturity. This may create phantom income, for the I Bond holder, if the holder chooses to pay tax annually on accrued interest income.

I Bonds have exceptional downside protection. With I Bonds, the bond's redemption value will not decline. This means that the accumulated income and principal adjusted for inflation can only go up, never down. Therefore, were deflation to occur, the I Bond accrued value would not decline.

I Bonds have liquidity, but must be held for at least six months after initial purchase in order to be redeemed. A penalty exists, relative to losing three months of interest, if an I bond is redeemed prior to 5 years after purchase.

Contrasting I Bonds and TIPS Bonds

I Bonds are U.S. savings bonds and are offered in smaller increments than TIPS. TIPS are sold in minimum increments of $1,000, whereas I Bonds are sold in denominations as little as $50 face value. I Bonds are inflation-indexed for up to 30 years, whereas TIPS are being offered by the Treasury in 5-, 10-, and 20-year offerings.

I bonds also offer a distinct feature from TIPS relative to deflation. A TIPS Bond, you will recall, cannot decline below its face value due to deflation. A TIPS bond's face value can decrease in value but not lower than its face value. An I Bond will not decline in value, but can only go up.

I Bonds offer potential tax deferral, whereas TIPS bonds do not.

TIPS Bonds will have market value fluctuation, whereas an I Bond has a fixed and determinable redemption rate. Unlike TIPS, which may be purchased without limit in multiples of $1,000, I Bond purchases are limited to a maximum of $30,000 per calendar year.

Conclusion

Inflation and market risks are here to stay. Historically, during good times and bad, inflation is always present. Money has always had a cost to borrow it. Therefore, if we can at least protect ourselves from the loss of value due to inflation, and have our rate of return adjust only upward based on inflation, we can eliminate part of the risk of owning a fixed-income security. Tie that together with liquidity, within certain parameters, and you have a government-backed vehicle that provides products that may be considered as part of your fixed income portfolio.

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