

INVESTMENT UPDATE

Is it Time for TIPS?

With all the discussion lately on the topic of rising interest rates, there has been renewed interest in the market for TIPS. For anyone needing a reminder, TIPS are “Treasury Inflation Protected Securities” (alternatively known as “TIIS—Treasury Inflation Indexed Securities”) and were first issued by the US Treasury in 1997. Unlike most bonds, these securities are designed to provide investors some degree of protection against an increase in inflation by indexing the bond’s principal to the consumer price index. When inflation rises, the adjusted principal value of TIPS goes up and their coupon income is calculated on this adjusted principal. When the bond matures the holder is paid the adjusted principal, which, during a period of inflation, will be higher than the original principal.

The Treasury has now come to market with 13 TIPS issues; 12 have been issued with 10- and 30-year maturities, the other was a five-year maturity that matured in 2002. The total value of the US TIPS market today is approximately \$214 billion, roughly 1/10th the size of the “conventional” Treasury market.

If US Treasury securities represent the “ultimate” in bond market liquidity and credit quality, TIPS are designed to be something even better, a Bond for All Seasons—a bond with characteristics that seemingly defend against all enemies of fixed income instruments. Yet the team at Agincourt has never invested in TIPS, and given TIPS’ current valuations, we aren’t likely to buy them any time soon. Why?

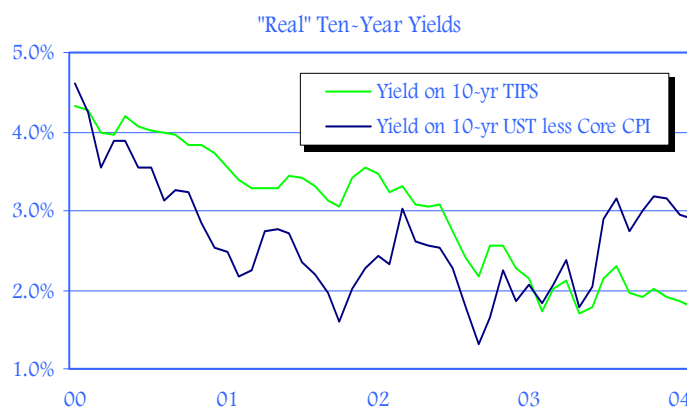
Our main objection to TIPS is that, in a world with no “free lunches,” given all their positive attributes TIPS must be lacking *something*. That something is yield.

Investors buy TIPS in order to guard against the erosive impact that rising inflation has on bond prices. They trade yield for a degree of safety. But “giving” yield is in direct opposition to our fundamental belief that “yield wins over time”—portfolios constructed of high quality bonds that possess good yield provide superior total returns. Because of their meager yields, we typically underweight conventional, non-inflation-protected Treasury notes in our clients’ portfolios; TIPS are even richer. Interest rates and bond prices move minute-to-minute and day-to-day, but with fixed income securities, even TIPS, the coupon stays the same. True, if inflation rises TIPS’ principal rises; but if one buys TIPS in anticipation of rising inflation and inflation stays the same or falls, a portfolio with low-yielding TIPS under-yields with every passing day.

In addition to their low yields, in the context of today’s market, TIPS are significantly overvalued. As the chart on this page demonstrates, investors of late have been paying a very high price for inflation protection. This chart shows how inflation-adjusted yields on nominal 10-year US Treasuries and 10-year TIPS yields (both representative of “real” 10-year yields) have diverged recently.

While inflation-adjusted USTs moved to overvalued levels (i.e., below 2%) in the period directly following the 9/11 tragedy, as well in 2002’s flight to quality and in last year’s market-rattling Fed announcement of “unconventional” measures to fight deflation, “real” UST yields have lately normalized back to the middle of their textbook 2%-4% range. Meanwhile, 10-year TIPS yields have not moderated over the past six months, and remain extremely “rich,” yielding less than 2%.

This seems counter-intuitive: if inflation is low and falling (as it has been over the past few years), we would expect investors to be less concerned with



inflation, and therefore less interested in bonds that offer inflation protection. Yet, paradoxically, TIPS have become increasingly overvalued as inflation has fallen! Even though inflation fears should have subsided, TIPS prices would imply that inflation expectations seem to have been ignited. One explanation is that TIPS prices have been bid up (with their yields moving correspondingly lower) by investors who are anticipating a rise in inflation from its 45-year low. While that's a possibility, we must also point out that the TIPS market is relatively small and subject to supply/demand imbalances and unusual price movements, especially given the sponsorship of TIPS by a handful of very large bond managers.

While TIPS may be temporarily rich, they are permanently difficult to trade. Part of the problem is the complexity of the securities themselves—the formula for calculating the principal amount is anything but straightforward. While Bloomberg offers a “page” that allows subscribers of their on-line systems to bypass the complex manual calculations, many back-office and portfolio accounting systems do not have these capabilities. Scores of investors simply don't want to go through the trouble and expense of trying to keep up with the daily bookkeeping necessary with TIPS. In addition to the accounting issues is the lack of liquidity provided by TIPS. TIPS don't have the depth and breadth of markets one expects from a Treasury-issued security. Given their lack of broad sponsorship, when a selling or buying program is initiated by one of the very large holders of TIPS, prices can move very quickly, and in unexpected directions.

There are other technical issues with TIPS that make them problematic, especially for total rate of return investors like Agincourt. Unlike conventional bonds (“rates go up, prices go down”), it is difficult to predict how TIPS will perform in a given interest rate scenario. Careful duration measurement of all securities in our clients' portfolios is central to our total return risk-management strategies; yet TIPS don't respond to changes in rates like normal bonds. As we've seen, they've performed surprisingly well over a period of declining inflation, a scenario most would have viewed as hostile for TIPS. The most we can say with confidence is that TIPS do well when *real* rates decline, but there are so many variables that impact real rates, both realized and projected, that even this rule isn't much help.

Given all the issues with TIPS, our response to the prospect of rising inflation is simply to shorten the average duration of our clients' portfolios. Not only is this a far more straightforward and measurable way of controlling risk, but the results are predictable for any

given scenario. In addition, we can preserve the yield of the portfolio by simply shifting some of the holdings of the portfolio into shorter maturities—moving just 10% of our portfolio into a basket of TIPS would equate to a 0.30% (30 basis points) yield penalty to the portfolio, far more than a modest shortening trade would cost.

We should mention that just because we view TIPS as unlikely candidates for our total return portfolios does not mean that there's no place for TIPS anywhere in the investment landscape. As Assistant Secretary for Federal Finance Timothy Bitsberger outlined in a speech last winter, “Treasury Inflation-Indexed Securities are a unique asset class.” While we might fault him for over-reaching when he stated that TIPS are an asset class that “every diversified investor should own,” there's no denying that TIPS have their place.

In particular, TIPS can provide value to certain “passive” portfolios that attempt to match assets with existing liabilities that are indexed to inflation. As an example, certain retiree health care plans may be able to benefit from having assets that will rise in value with inflation. Care must be taken even here, however, to try to align the inflation measures: TIPS use the CPI for urban consumers, which may not necessarily match with future increases in liabilities' costs, much less future increases in benefits that these plans are seeking to insulate against. Still, for “dedicated” portfolios, TIPS can help protect assets from some forms of inflation.

TIPS may also make sense for certain individual investors who are on a fixed income and are most concerned with real capital preservation. In this case, indexing can protect the value of their assets if inflation rises. Of course, the TIPS yield will be low, so if inflation doesn't rise, the portfolio won't generate as much income as it would if invested in conventional bonds.

Would we ever consider buying TIPS? Sure. As we often remind ourselves, “there are no bad bonds, only bad bond prices”—nearly any bond is attractive if the price is right. Currently, TIPS prices are extremely overvalued; but that is certain to change. If our outlook is correct, TIPS may underperform significantly in a rising rate environment if investors demand higher real yields. Depending on what else is out there, TIPS' prices could fall sufficiently so that they could become an attractive alternative for our total return portfolios.

