



Common Questions Regarding TIPS

Despite strong advantages versus other fixed income instruments, TIPS are generally a small allocation of investors' fixed income portfolios. One possible reason is that investors don't understand this relatively new instrument. The following answers some common questions regarding TIPS.

As Larry Swedroe discusses in the chapter on Treasury inflation-protected securities (TIPS) in his book *The Only Guide to Alternative Investments You'll Ever Need*, the academic literature comes down squarely on the side of TIPS as a preferred fixed income investment. Despite the recommendations from academics, many individual investors still have a very low allocation to TIPS. There are two likely explanations. First, they are unaware of the literature recommending TIPS. Second, TIPS are still a relatively new instrument, and investors simply don't understand them. The following are answers to some of the more common questions on TIPS.

Is there a risk premium (cost) TIPS investors pay for hedging the risk of inflation protection?

In theory, investors should expect TIPS to have lower expected returns than nominal Treasury bonds of the same maturity. The yield (and expected return) of a nominal Treasury bond consists of three components:

- s The real yield (which should be the same as the real yield on TIPS)
- s The expected inflation rate
- s A risk premium for unexpected inflation

The expected return on TIPS consists of just the first two components. Thus, investors in nominal bonds receive the risk premium for unexpected inflation while TIPS investors do not.

What is the size of the risk premium?

Most investors estimate the size of the premium by subtracting the yield on TIPS from the yield on a comparable nominal Treasury note. For example, if the yield on a 10-year nominal Treasury note is 3.7 percent and the yield on a 10-year TIPS is 1.9 percent, they calculate the expected inflation rate as 1.8 percent. That calculation provides investors with the breakeven inflation rate. If inflation is 1.8 percent, both bonds will provide the same return; if it is higher, TIPS will outperform and vice versa. However, it may not tell what the risk premium is. The reason is that there is a fourth factor that can influence yields, one that becomes especially important in times of crisis. That factor is liquidity.

Given that there are more than \$500 billion of TIPS outstanding, one would think they are highly liquid investments and should not carry much of (if any) illiquidity premium compared to nominal Treasuries. However, TIPS represent less than 10 percent of all Treasuries outstanding.¹ In addition, because most TIPS are owned by buy-and-hold investors, only a small fraction of TIPS are available to be traded. Thus, they are less liquid instruments than nominal Treasuries.

How can we estimate the risk premium?

This can be done by looking to the over-the-counter swaps market for inflation. The current market shows an inflation estimate of about 2.7 percent for the next 10 years. If we subtract the inflation estimate of 2.7 percent from the current yield of 3.7 on nominal 10-year Treasuries, we can see that the expected real return on the 10-year nominal bond is 1 percent. Given that 10-year TIPS are



yielding about 1.9 percent, it appears that TIPS investors do not have to pay a risk premium. And that makes them an even more compelling choice relative to nominal bonds.

Why is there the seeming anomaly of a negative premium?

The reason for the negative premium for unexpected inflation is that investors in nominal bonds are “paying up” (driving yields down) for the liquidity that nominal Treasuries provide (as nominal Treasuries are the most liquid security in the world). Note that individual investors who will typically be holding TIPS in tax-advantaged accounts generally have no need for liquidity (except to meet the required minimum withdrawal). Thus, they have no need to “pay up” for liquidity.

Is that premium constant, or does it vary depending on the inflationary environment?

First, as we discussed, flights to liquidity can impact the premium. Second, logically, if there is a perception of heightened risk of inflation, investors would demand a greater premium. And if there was a perception that deflation was likely, the premium could even turn negative. Thus, the premium should not be expected to be constant.

Sources

The following sources were used by the author(s) to arrive at the above conclusions.

- ¹ **Monthly Statement of the Public Debt of the United States.** Available at <http://www.treasurydirect.gov/govt/reports/pd/mspd/2009/opds052009.pdf>. Accessed June 15, 2009.

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