

Treasury Inflation-Protected Securities (TIPS) Basics

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What are Treasury Inflation-Protected Securities (TIPS)?

Treasury Inflation Protected Securities (TIPS), are inflation-indexed government bonds whose principal amount is adjusted periodically for inflation. A fixed interest rate is paid semi-annually on the adjusted amount. They may also be referred as Treasury Inflation-Indexed Securities (TIIS).

Overview of the TIPS Market:

Established in 1997 by the US Treasury, TIPS have grown rapidly into an integral part of the bond market. With almost \$200 billion outstanding, TIPS allow the Treasury to broaden its investor base and diversify its funding risks, as well as supply the demand from investors to offer inflation protected securities. Liquidity in the TIPS market is improving, with daily trading volume nearly doubling in the past two years.

Key Features of TIPS:

The interest rate, which is set at auction, remains fixed throughout the term of the security. The principal amount of the security is adjusted for inflation, but the inflation-adjusted principal will not be paid until maturity. Semiannual interest payments are based on the inflation-adjusted principal at the time the interest is paid.

The index for measuring the inflation rate is the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U), published monthly by the Bureau of Labor Statistics (BLS).

The auction process uses a single-price

auction method that is the same as that currently used for all of the Treasury's marketable securities auctions. At maturity, the securities will be redeemed at the greater of their inflation-adjusted principal or par amount at original issue.

How TIPS Add Value: An Example

An investor buys \$1,000 worth of a new, 5-year inflation-indexed note paying 3% interest. At the first coupon payment, the CPI indicates that inflation has been 1% during the last six months. The investor's principal amount is then adjusted upward from \$1,000 to \$1,010. The interest payment (one-half of 3%) is based on the new figure, so the first semiannual interest payment is \$15.15. (Calculated as \$1,010 times 3%, divided by 2). This process would be repeated at all subsequent coupon payment dates (i.e. adjusted for new CPI data every 6 months).

Advantages of TIPS:

- The principal is protected against inflation. Since the principal is indexed to CPI and grows with inflation, the investor is guaranteed that the real purchasing power of the principal will keep pace with the rate of inflation.
- The investor will receive semiannual interest payments, based on a fixed semiannual interest rate applied to the inflation-adjusted principal, so the investor is guaranteed a real rate of return above inflation.
- Backed by the full faith and credit of the United States Government.
- Like other marketable Treasury securities, TIPS are exempt from state and local income taxes.

Disadvantages of TIPS:

- Deflation will cause a slower increase in TIPS value or result in no increase in value at all.
- Because of the inflation protection feature, these securities usually offer lower coupon rates than nominal Treasuries of similar maturities without the feature.
- Income is subject to federal income tax.
- When the principal grows, that gain is considered reportable income for that year even though the investor won't receive his or her inflation-adjusted principal until the security matures.

Summary:

We Recommend the Purchase of Treasury Inflation-Protected Securities (TIPS)

In addition to being backed by the full faith and credit of the United States Government, TIPS can be an excellent way for investors to protect the future real purchasing power of their investment. TIPS offer a bond portfolio good diversification and liquidity. We recommend the purchase of Treasury Inflation-Protected Securities (TIPS).

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