TIPS for a Low-Inflation Climate

In an **article** for WSJ.com, **Michelle Perry Higgins** discusses Treasury inflation-protected securities (TIPS), and how they may fit into bond allocation strategies in a low-inflation environment.

When TIPS are issued by the Treasury they come with an interest rate that doesn't change, like most bonds. The inflation protection works through increases in the principal value of the bond to which the fixed rate is then applied. Increases in the principal value of the bond are tied to increases in the Consumer Price Index (CPI). If the CPI decreases in a deflationary environment, the value of TIPS could decrease as well so that the interest amount received by the investor would also decrease. However, at maturity the investor receives at least the original principal value of the bond so downside risk is mitigated.

While TIPS may help protect against inflation, they do not guard against increases in interest rates unless rising rates are accompanied by increasing inflation.

In addition, when TIPS are held outside of retirement accounts, the increase in principal that occurs with an increase in inflation must be reported as income for tax purposes–even if the TIPS is not sold. This is the phenomena of "phantom" income – tax without the corresponding income to pay for it.

According to Higgins, TIPS may be a good idea as part of your bond allocation *if* you believe future inflation will be higher than expected inflation–and if you are comfortable with the caveats mentioned above.

To learn more about TIPS, be sure to read these information AAII articles:

- **TIPS and the Nature of Inflation Protection**
- **TIPS for Inflation-Proofing Your Portfolio: A Guide to Inflation-Indexed Securities**