

Understanding TIPS



What Are TIPS?

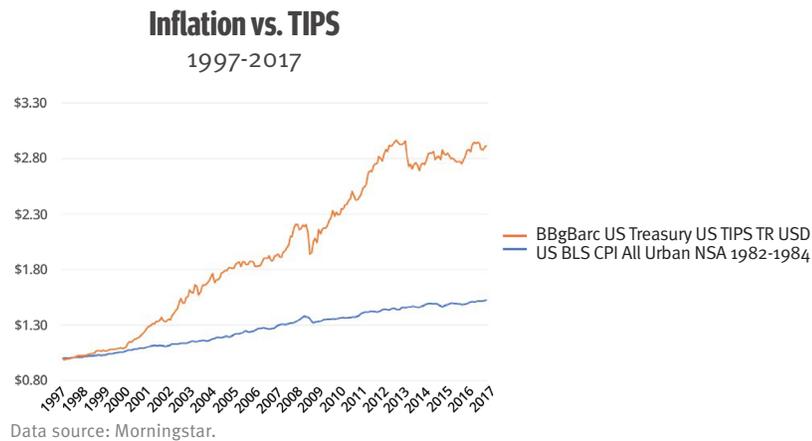
Treasury Inflation-Protected Securities, or TIPS, are a type of bond issued by the US Treasury. They are backed by the full faith and credit of the US government. TIPS are designed to provide **a low-risk way for investors to preserve purchasing power** and protect against the adverse effects of rising prices (inflation) over the life of the bond.

How Do TIPS Work?

TIPS are issued with a fixed coupon rate, but **their principal value is indexed to inflation**. That means their **principal value rises and falls with changes in the rate of inflation**. Although the coupon rate is fixed, actual coupon payments also rise and fall. This happens because interest is calculated on the changing principal value as it is adjusted for inflation.

Have TIPS Provided Protection?

Over the long-term **TIPS have provided excellent protection against inflation**. The graphic below shows that TIPS have historically far outpaced inflation.



But other asset classes, including stocks, real estate, and some fixed income securities have provided even better protection.

When Do TIPS Make Sense?

The yield on TIPS is usually lower than the yield on traditional Treasury securities with a comparable maturity. That is because traditional Treasury securities have expectations about future inflation rates already built into their yields.

- If actual inflation is higher than the market expects it to be, TIPS would be a better investment than a traditional Treasury with a comparable maturity.
- If the market's expectations are on target, both will provide an equivalent return.
- If the market's expectations about inflation turn out to be too low, the traditional Treasury security would be the better investment.

TIPS and Taxes

The principal value of TIPS is adjusted twice a year for inflation. Any adjustment is subject to ordinary federal income tax. You won't receive any increase in principal until the TIPS matures, but you will be required to pay taxes on those increases as the adjustments are made.