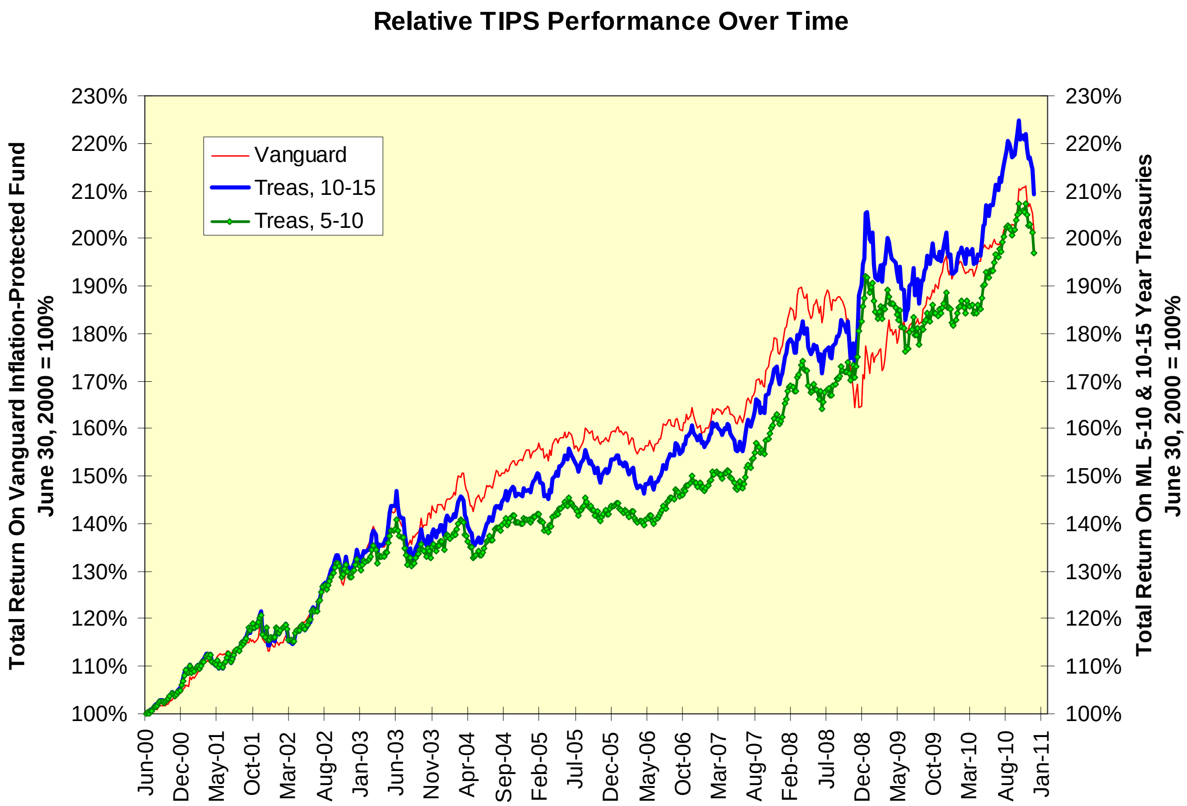
TIPS Are Still Bonds

Tradition has it Roman generals engaging in a triumphal parade would have a servant standing behind them whispering, "*Memento mori*," which is Latin for either "Remember, thou art mortal," or "Brutus gonna stab you silly."

Classicists prefer the former translation, but they are a dull lot.

Perhaps fixed-income investors should hire someone to whisper in their ears, "Remember, TIPS are still bonds." This lesson seems to be forgotten willingly by most investors and deliberately by the financial services industry which loves to stuff TIPS into all manner of what they dub "real return" vehicles. While TIPS will provide you with a taxable accrual linked to changes in the All-Urban CPI, not seasonally adjusted (CPI-U), their ability to generate a return in excess of conventional Treasuries depends on sellers underpricing inflation insurance. Let's update the chart used in that March article comparing the total return of the Vanguard Inflation-Protected Securities Fund in light of the intervening bond bull run and current retreat.

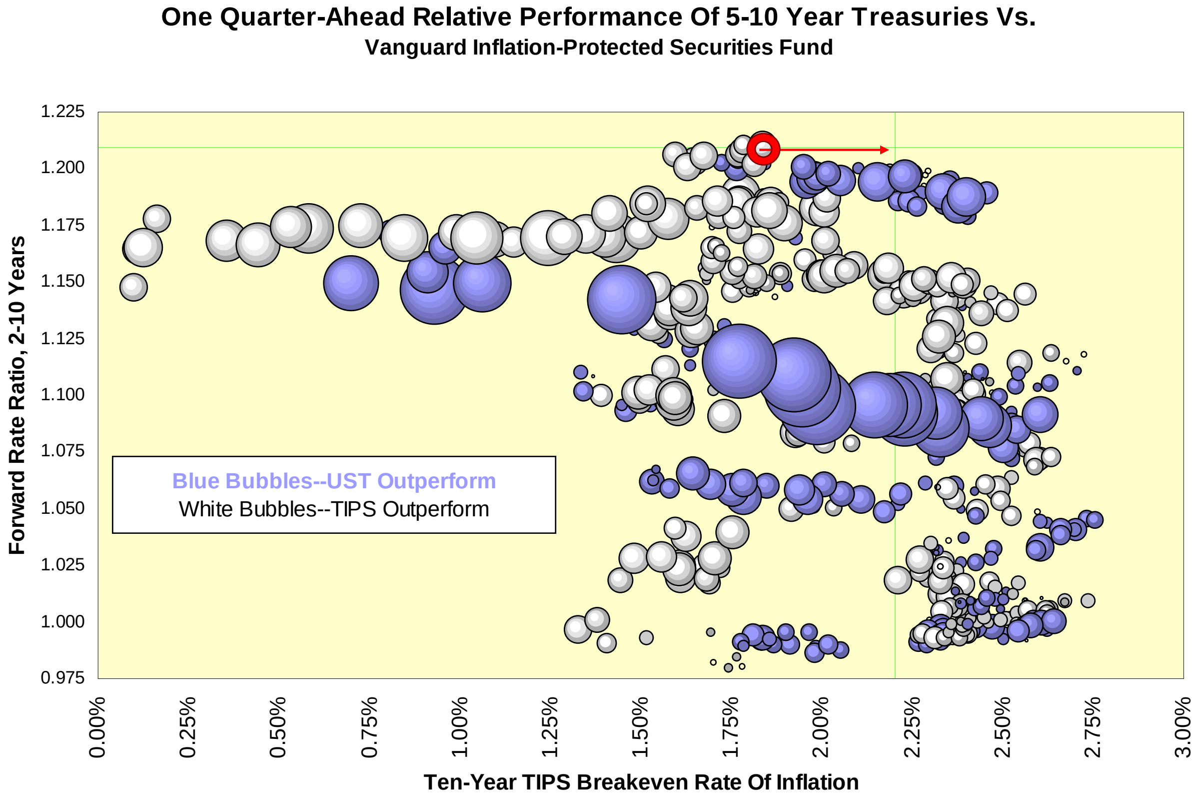


The comparative total returns since QE2 began on November 4, 2010 are -4.76% for the Vanguard fund, -6.32% for the Merrill Lynch index of 5-10 year Treasuries and -7.66% for the ML index of 10-15 year Treasuries. Ten-year TIPS breakeven rates of inflation have jumped from 2.08% to 2.32% over the same period.

Now we have to ask whether the glass is half-full; did the lower loss on the TIPS portfolio in the face of rising inflation expectations satisfy their investors or were many of these same investors surprised at how quickly longer-term Treasury bonds can lose value? I will say, "Both," not only because it is the easy way out but because both alternatives have merit. However – and I will hold myself to this – I will go on record as saying further losses on TIPS portfolios in a combination of higher interest rates and realized changes in the CPI-U no greater than implied in the current breakeven rate will lead to a bevy of arbitration claims, lawsuits and any two Biblical plagues of your choosing.

Where Now?

We can map three month-ahead relative performance of the Vanguard fund relative to 5-10 year Treasuries as a function of current breakeven rates and the shape of the yield curve as measured by the forward rate ratio between two and ten years ($FRR_{2,10}$). This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself; the steeper the yield curve, the more the $FRR_{2,10}$ exceeds 1.00. Blue bubbles represent points where the Treasury outperforms; the datum from three months ago is highlighted in red and the current environment is marked with a green bombsight.



The current configuration argues for conventional Treasuries to outperform TIPS through the first quarter of 2011. This is a relative, not an absolute, statement. Should interest rates jump, TIPS will lose on an absolute basis, and many investors will be absolutely surprised and absolutely unhappy with that outcome. Remember, they are still bonds and not loss-protection vehicles.