Free Inflation Insurance. Inquire Within

There is an old saying Army equipment is designed by geniuses for use by non-geniuses. There are counterparts to this in civilian life where we see some very bright people making huge amounts of money by providing the rest of us with things such as microprocessors, nanosphere-encapsulated pharmaceuticals and the Slap-Chop™. But in my experience, the most successful entrepreneurs on a day-in, day-out basis are those who sell things that sound good but do not work as advertised to, um, non-geniuses.

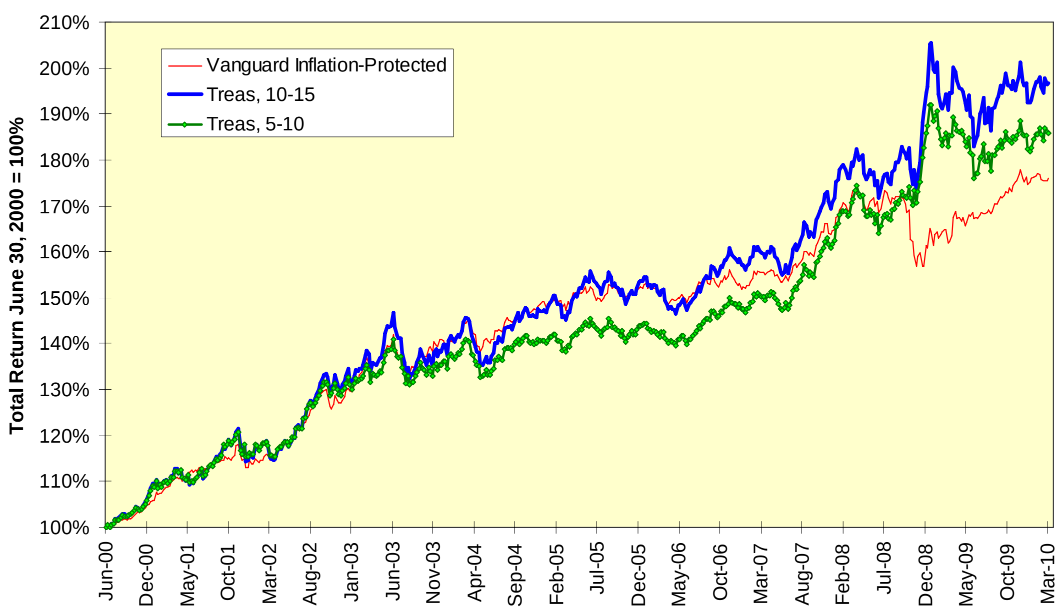
Take the TIPS market, please. In one of the more willing acceptances of conflict-of-interest on the planet, investors allow the Treasury to issue low-coupon bonds to them in return for a taxable accrual based on the All-Urban Consumer Price index, Not Seasonally Adjusted (CPI-U). The buyer thus is relying on the seller to define what the inflation rate was and what the rate of taxation on that non-cash accrual will be over time. You do not have to fly a black helicopter to work to realize this is being short two options on government honesty, one on the reporting of inflation and one on future tax treatment of the accrual. In the meantime, the Treasury is paying a lower coupon rate and the TIPS holder is receiving less short-term coupon income to receive at today's might fine short-term yields.

Equivalence
The TIPS market promises to provide a modicum of protection against inflation, which places it in the category of insurance. Think about the other instances of insurance in your life, be it automobile, health, life or home. In all cases the insurer assesses the actuarial risk involved, charges a premium, invests the money received and hopefully has enough left over at the end to avoid bankruptcy. The insurer may reinsure the risks as well.

The key is the seller has to cover the expected payouts on the policies and will be unwilling to sell the insurance below that actuarial level, at least willingly. Why should it be different in the case of inflation insurance (Hint: It is not).

If the market is operating efficiently, the total return on TIPS must be less than or equal to the return on conventional Treasuries. We can illustrate this by comparing the total return of the Vanguard Inflation-Protected Securities Fund (VIPSX) to the total returns on the Merrill Lynch indices of 5-10 and 10-15 year Treasuries; all series are reindexed to June 30, 2000.

TIPS Underperform Nominal Treasuries Over Time



There was one brief and possibly shining moment in 2003-2004 when the Vanguard fund outperformed the conventional Treasuries, but it has underperformed the 10-15 year Treasuries continuously since September 2006 and the 5-10 year Treasuries since September 2008. Neither date is an accident: The Federal Reserve ended its series of seventeen consecutive rate hikes in August 2006 and accelerated its monetary flood during the September 2008 financial crisis.

The lesson is clear: If investors are expecting inflation to rise, so are the sellers of TIPS and they are just as unlikely to sell you underpriced insurance against inflation as an auto insurer is to sell you underpriced auto insurance. This means TIPS can outperform Treasuries only when realized gains in the CPI-U outpace the rate of inflation expected at time of purchase.