Worried About Inflation? Consider TIPS

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Key Points

- Treasury Inflation-Protected Securities can help protect portfolios from rising inflation.
- The cost of inflation protection is relatively low today.
- TIPS yields are negative, so keep total return expectation in check.

Worried about inflation? Treasury Inflation-Protected Securities, or TIPS, can help protect your portfolio against rising inflation.

When building a diversified portfolio, positive total returns aren't the only thing to consider—making sure your investments keep pace with inflation is important as well. Because the principal value of TIPS rise and falls with the level of inflation, they can help your portfolio keep pace with inflation.

Before investing in TIPS, there are some important nuances to be aware of today, like negative yields and the cost of inflation protection.

TIPS—the basics

TIPS are a type of Treasury security whose principal value is indexed to inflation. As the level of the Consumer Price Index (CPI) rises and falls, so too does the value of a TIPS. Like traditional Treasury securities, TIPS have fixed coupon rates based off of the principal value—so coupon payments also rise or fall with the level of the CPI as the principal value fluctuates.

This characteristic helps TIPS protect investors against the effects of inflation, because they'll be rewarded with a higher principal value at maturity as well as growing coupon payments if inflation is rising. (Traditional Treasuries simply mature at their $1,000 par value.) The opposite is true as well: In deflationary periods, the principal value of a TIPS will fall, resulting in smaller coupon payments. At maturity, however, a TIPS investor would receive either the adjusted principal or the original principal value. In other words, TIPS never pay back less than the initial principal value at maturity.

Considerations for today's investing environment

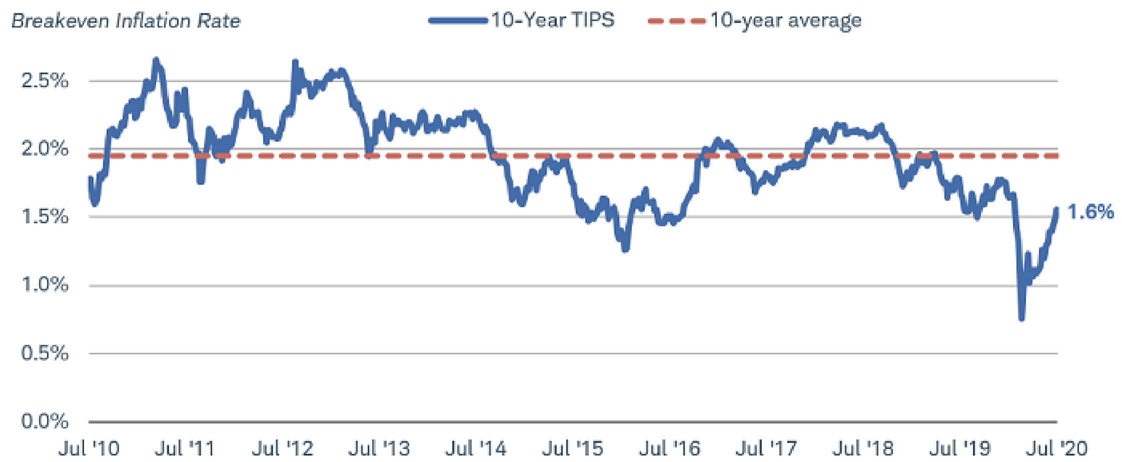
While TIPS may seem like a straightforward way to keep pace with inflation, here are a few things to keep in mind when considering TIPS relative to traditional Treasuries:

1. The cost of inflation protection is relatively low. One way to evaluate TIPS is through the breakeven rate, or the rate at which inflation (as measured by the headline CPI index) would need to average over the life of a TIPS for its total return to "break even" with the total return of that comparable Treasury security.Today, breakeven rates are relatively low, so it doesn't take a large amount of inflation for TIPS to outperform nominal Treasuries.

The breakeven rate is calculated as the difference between the yield of a nominal Treasury and the yield of a TIPS with a similar maturity. For example, if the yield of a 10-year Treasury note is 0.6% and the yield of a 10-year TIPS is -1.0%, the breakeven rate is 1.6%. Nominal Treasury yields are usually higher than TIPS yields because they don't get the benefit of principal adjustments for future inflation.

Given this, if inflation averaged more than 1.6% over the 10-year investment horizon, then the TIPS would generate a higher total return than the traditional Treasury note. Conversely, if inflation averaged less than 1.6% over that 10-year span, then the Treasury would outperform the TIPS.

Breakeven rates are still relatively low

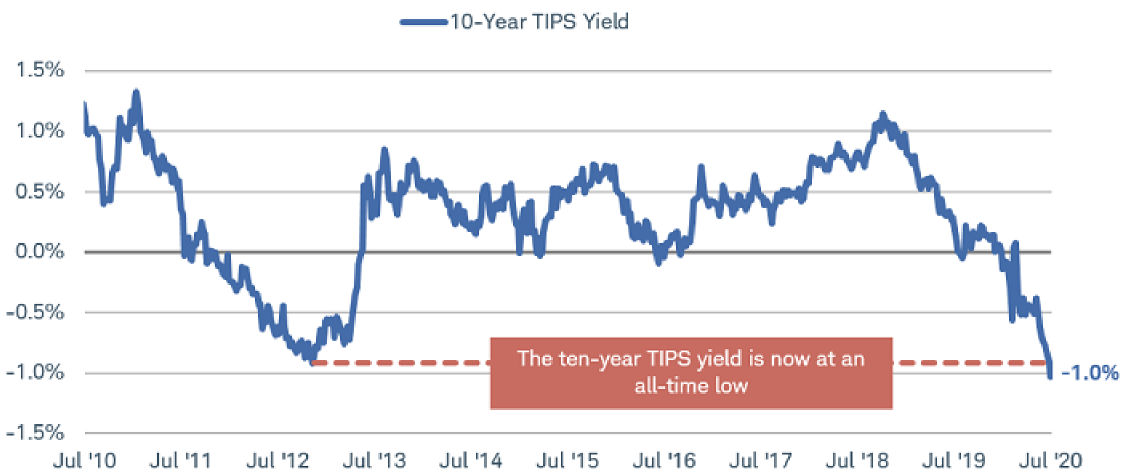


Source: Bloomberg, using weekly data as of 7/31/2020. TIPS 10 Year Breakeven Inflation Rate (USGGBE10 Index). **Past performance is no guarantee of future results.**

Even with the recent rise from the March lows, TIPS breakeven rates remain below the 10-year average and are still at the low end of their 10-year trading range. In other words, the cost of inflation protection is low, making TIPS relatively attractive for investors worried about inflation over the long run.

2. Negative real yields. While breakeven rates can give you a relative valuation of TIPS compared to nominal Treasuries, the actual yields they offer are in absolute terms—and in absolute terms the yields are at all-time lows. TIPS of all maturities currently offer negative yields, with 10-year TIPS yields matching the all-time low of -0.9% from 2012, and even the long 30-year TIPS yield is in negative territory at -0.4%.

The 10-year TIPS yield is now at an all-time low



Source: Bloomberg, using weekly data as of 7/31/2020. US Generic Govt TII 10 Yr (USGGT10Y Index). **Past performance is no guarantee of future results.**

What does a negative TIPS yield mean? For an investor who purchases a TIPS with a negative yield and holds it to maturity, that annualized total return will underperform the rate of inflation, regardless of the level of inflation.

While that may spook some investors, consider nominal Treasury yields today compared to the inflation rate. The 10-year Treasury note currently offers a yield of roughly 0.6%, while the most recent reading of the year-over-year change in CPI was 0.6%. When adjusted for inflation, the 10-year nominal Treasury yield is right near zero. And if an investor were to purchase a 10-year Treasury with a yield of 0.6% and inflation were to remain meaningfully higher than that 0.6% yield, then its annualized inflation-adjusted return would likely be negative as well.

There might be some sticker shock with negative TIPS yields, but the higher inflation rises, the greater the nominal (non-inflation-adjusted) return would be.

3. TIPS are indexed to CPI. There's no shortage of inflation indicators, and no shortage of opinions on what the actual level of inflation is. But when it comes to TIPS, the CPI is the indicator that matters most, because TIPS principal values are indexed to it.

4. TIPS are still bonds, and are still subject to the inverse relationship between bond prices and yields.

Over the long run, the rate of inflation is a large factor in how a TIPS performs. But over the short run, fluctuations in its price tend to influence total returns more. For example, if TIPS yields were to rise (sending TIPS prices lower) at the same time that inflation was rising, the price decline could more than offset that inflation adjustment to the principal, and short-term returns could be disappointing.

5. Manage your total return expectations. Given the negative yields that TIPS provide, and expectations that inflation may be low given the COVID-19-driven slowdown, total return expectations should be held in check. While they can help protect portfolios against rising inflation, total returns are likely to be relatively low given the starting point of negative yields.

What to do now

Investors looking to protect against inflation should consider adding TIPS to their portfolios. On a relative basis, TIPS can make sense compared to traditional Treasuries today given the relatively low breakeven inflation rates. However, on an absolute basis, it’s important to keep your return expectations in check given negative yields.

There are a few ways to invest in TIPS. Investors who prefer to invest in mutual funds or ETFs can browse potential funds on the Mutual Fund Select List or the ETF Select List. When browsing each list, first select “Taxable Bond” as the type of fund, then search for funds in the “Inflation-Protected Bond” category. Please note that many mutual funds in this category invest in many different types of bonds to outperform inflation—they don’t always invest exclusively in TIPS. ETFs, on the other hand, often offer more of a pure play on the TIPS market than mutual funds.

If you’re a Schwab client and you prefer owning individual bonds, you can log in and find TIPS on the client center on Schwab.com under the “Find Bonds & Fixed Income” page. Once there, select “Treasuries” as the bond type, and then below select “Include Only Treasury Inflation-Protected Securities (TIPS).”

Important Disclosures:

Investors should consider carefully information contained in the prospectus or, if available, the summary prospectus, including investment objectives, risks, charges, and expenses. Please read it carefully before investing.

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Treasury Inflation Protected Securities (TIPS) are inflation-linked securities issued by the U.S. government whose principal value is adjusted periodically in accordance with the rise and fall in the inflation rate. Thus, the dividend amount payable is also impacted by variations in the inflation rate, as it is based upon the principal value of the bond. It may fluctuate up or down. Repayment at maturity is guaranteed by the U.S. government and may be adjusted for inflation to become the greater of the original face amount at issuance or that face amount plus an adjustment for inflation.

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