Taking Stock: TIPS make a good hedge against inflation

by Malcolm_Berko

Dear Mr. Berko: Please tell me about TIPS, or Treasury Inflation Protected Securities. Please tell me how they work and if you think they will be a good hedge against inflation due to the huge pile of money that the government is spending on the stimulus package and the TARP. I have an independent retirement account that has lost nearly 60 percent in the past 12 months. At age 57, I'm considering liquidating the remaining $209,000 and putting it into TIPS. Please tell me if this is a good idea. â€” M.G., Lady Lake, Fla.

Dear M.G.: My good friend "Downtown" Bobby Brown told me that the secret to the phenomenal success of his eight barbecue restaurants is that every server strives for TIPS, or To Insure Prompt Service. And I'm convinced that the secret to your success in the stock market over the next dozen or more years can be TIPS, or Treasury Inflation Protected Securities.

The U.S. Treasury Department has been issuing TIPS since 1997, and like all government securities, TIPS are 100 percent guaranteed by the U.S. government. You've probably never heard of them because the commissions are so small ($12.50 to purchase $50,000 face value) that fee-for-service brokers can't make money recommending them. But by Jove and by gosh, TIPS, especially for seniors who must have absolute safety, could be the greatest thing to come along since suitcases on wheels.

Interest payments are made twice a year and vary with the consumer price index. If inflation occurs, the principal value of your TIPS increases. If deflation occurs the principal value decreases. So, the principal value of your TIPS increases or decreases according to the CPI, and that principal value is adjusted every six months. Meanwhile, your interest rate is applied to the inflation-adjusted principal, not the original $1,000 face value. So, if inflation continues through the lifetime of the bond, each interest payment will be greater than the previous payment. Of course, the converse is true in event of deflation. At maturity, Treasury will pay the bondholder the greater of either the inflation-adjusted principal or the original $1,000 face value.

However, you should know that since 1948 there were only two year in which we did not have inflation: 1949 and 1955, when inflation was a minus-0.95 percent and minus-0.28 percent respectively. And since the Treasury Department began issuing TIPS in 1997, the total cumulative inflation for those 12 years was 68.71 percent. Because this is an annual compounding, the value of a 1997 TIP has nearly doubled and so have the semi-annual interest payments.

The following is a hypothetical example.

Suppose you have $100,000 invested in TIPS that pay 2 percent, or $2,000, per year. If inflation is 4 percent for the first year, your principal amount increases from $100,000 to $104,000. Now, though the interest rates have not changed, you're earning more interest (2 percent times $104,000) or $2,080. And if the CPI grows by 5 percent the following year, your principal value grows to ($104,000 times 1.05 percent) $109,200. And the interest that year is (2 percent times $109,200) $218.40. And if the CPI grows by 5 percent again in 2011 the principal value increases to ($109,200 times 5 percent) $114,660 and your interest at 2 percent becomes $229.32. The only downside is that these principal adjustments are considered income in the year they occur, so you might have to pay federal income taxes on the principal increase.

Now many economists are concerned that the Treasury Department is printing and printing thousands of pounds of $100 bills every day. They rightly compare this frenzy to the hyperinflationary German printing presses of the 1930s, when a wheelbarrow of deutschmarks would purchase a loaf of bread on Monday but just 10 slices on Wednesday.

Well, the amount of dollars in circulation today is increasing significantly faster than the available goods and services in the economy. Because this massive increase of dollars in circulation causes the dollar to be worth less, it takes more of those new dollars to buy a loaf of bread today than it did last week. That's called inflation.

Our currency is supposed to be "storehouse of value," but the supply is increasing so rapidly that some folks consider it a horror house for economic calamity. And TIPS, which can provide you with an increasing semiannual income and principal growth, are an excellent hedge against this possibility. Now, most brokers don't understand how TIPS are priced, valued and traded â€” so an inexperienced broker can foul your goals. It's very important that you are working with a knowledgeable professional who is intimately familiar with all the working parts of TIPS.

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