



TO YOUR WEALTH Update

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Inflation-Protected Bonds

Clearly the current focus in the financial markets is on stocks and their continuing decline. However, a variety of government bonds offer additional consideration for investors. Treasury Inflation-Protected Securities (TIPS) and Series I Savings Bonds are the two government bonds which incorporate inflation protection for investors.

TIPS pay interest based on their initial coupon rate determined when they are first issued. However, the amount of interest received fluctuates based on inflation during the life of the bond as well as the final amount repaid upon maturity. Here's how it works:

The investor buys \$1,000 of TIPS paying 2% interest. Normally, the investor would earn \$20 during the first year. However, if inflation increases by 3% during the year, the original principal amount increases to \$1,030 so the interest earned during the second year would be \$20.60. Not only did the investor's interest amount increase by 3% but the principal amount increased by 3% too making the total return during the first year \$50 or 5% (which equals the 2% interest plus 3% inflation adjustment). The interest is paid every six months and the increases are determined using the Consumer Price Index (CPI-U).

At maturity, the investor will receive the greater of the original principal amount when the bond was first issued or the inflation-adjusted principal amount. The original principal amount is paid only if there is deflation over the life of the bond and the inflation-adjusted amount declined significantly. If the investor decides to sell the bond before maturity, then the price will be based on current market conditions just like any other bond.



All interest earned during the life of the bond is taxable in the year it is received. Additionally, the principal increases due to inflation are also treated as taxable income each year (even though the amount is not received until maturity). Due to this "phantom" income, it is usually best to hold TIPS in tax-deferred accounts such as IRAs.

An alternative to TIPS are the Series I Savings Bonds (I-Bonds) also issued by the U.S. government. They pay a fixed rate (0.70% for bonds purchased prior to May 1) plus inflation which is adjusted every six months (currently 4.92%) for a total return of 5.64%. The inflation rate changes each November and May which means the recent lack of inflation will most likely significantly reduce the bond's return this spring. Nevertheless, when compared to current earnings from savings and CDs, I-Bonds are an attractive alternative.

While TIPS can be sold at any time in the secondary market, I-Bonds must be held for at least one year. If they are redeemed within five years, the investor loses the last three months of interest. Investors can purchase an almost unlimited amount of TIPS but are limited to \$5,000 paper I-Bonds and \$5,000 electronic I-Bonds each calendar year.