TIPS: Valuable but Widely Misunderstood

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Clients count on financial advisors to keep their investments on track through challenging markets. With inflation at a 40-year high, your clients may have questions about how to protect their income and investments. One of the tools you might use is TIPS – Treasury Inflation Protected Securities.

TIPS can be useful for helping guard portfolios against inflation risk — but they can be complicated for investors and advisors alike. And they're often misunderstood. Before you dig further into their potential for your clients, let's look at five common misconceptions.

Misconception number one: TIPS tracks the Seasonally Adjusted Consumer Price Index. It's true that TIPS principal adjusts for inflation and those changes can boost TIPS coupon payments. But TIPS track a different gauge of inflation than the one that's usually reported in the media. While news reports focus on the seasonally adjusted Consumer Price Index, TIPS track the non-seasonally adjusted Consumer Price Index, called CPI-NSA. The two inflation benchmarks often diverge—so your clients' TIPS may not match the inflation they're reading about.

Misconception two: TIPS adjust for inflation immediately. In practice, there's a three-month lag between inflation and the change in TIPS principal. Inflation that happens in one month is reported in the next. In the third month, TIPS principal adjusts a little each day. It isn't until month four that the first month's inflation fully shows up in TIPS' principal and coupon payments.

Misconception three: TIPS don't adjust downward for deflation. Actually, TIPS' principal and coupon payments decrease if deflation occurs. That said, investors who hold to maturity are guaranteed to receive at least their original principal back.

Misconception four: Inflation is the main factor affecting TIPS performance. The reality is interest rates can affect TIPS' returns at least as much as inflation does. Increases in interest rates hurt TIPS' values, just like they do for other fixed-rate securities. In fact, between 2003 and 2021, interest-rate changes had a bigger impact on TIPS' returns than inflation did.

Misconception five: TIPS outperform when inflation is high. In fact, expected inflation is always priced into TIPS values and yields. That means TIPS outperform comparable Treasuries only if inflation turns out to be higher than the market anticipated at the time the TIPS was purchased. Say investors anticipated a 3% inflation rate over the next five years:

- If inflation matched expectations, TIPS would offer no advantage over a comparable Treasury.
- In this example, TIPS would outperform Treasuries if inflation was higher than 3%.
- But if inflation fell short of 3%, Treasuries would beat TIPS.

This dynamic holds no matter how high inflation is. If inflation runs at 9% but the market priced in 10%, TIPS' returns will lag Treasuries.

So to recap, TIPS can be an effective tool to help manage inflation risk. But when considering TIPS for your clients keep these key points in mind:

- TIPS track non-seasonally adjusted CPI, not headline inflation
- There's a three-month lag in TIPS adjustments
- TIPS payments decrease with deflation
- Interest rates have a big impact on TIPS returns
- TIPS hedge unexpected inflation, not expected inflation

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