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Memo

To: MDE Clients & Friends
From: The MDE Group
Date: June 15, 2009
Re: **Treasury Inflation Protected Securities: An Opportune Investment?**

Introduction

Recently, many financial analysts have been quoted in the media extolling the investment virtues of Treasury Inflation Protected Securities (TIPS). TIPS are U.S. Government bonds, whose payments are linked to the Consumer Price Index (CPI), the primary gauge of inflation in the United States. In contrast to traditional bonds, TIPS may rise in value as inflation and interest rates increase since both interest and principal payments are reset upward as the CPI increases. Below, we analyze the investment merits of TIPS under several economic scenarios.

Performance of TIPS and U.S. Treasuries under Four Different Economic Scenarios

It is logical to believe that the yield on U.S. Treasury securities will increase over the long run, given their exceptionally low current levels. To test the expected performance of a bond strategy, it is necessary to specify the manner in which interest rates will change over time and also the maturity date of the bond. TIPS are sold with three possible maturities – 5, 10, and 20 years. Our analysis focuses on the 10-year issue, but the conclusions would be similar for the shorter or longer dated bonds.

We analyzed **four different interest rate scenarios**:

1) The **first scenario** assumes inflation spikes within one year from their current levels of 1% to an annual rate of 6%. We obtained the 6% figure from PIMCO Co-CEO, Mohammed El Erian's research on inflation and assumed the CPI would stay at the 6% level for the remaining time to maturity. Under this scenario, TIPS provide an annual internal rate of return of 2.84% versus an annual loss of 3.57% for the 10-Year U.S. Treasury Bond.

2) The **second scenario** assumes a gradual rise in inflation, starting at the current 1% level and ending in year 10 at 6%. The returns to the second scenario are similar to the first, with TIPS providing an annual return of 2.84% versus an annual loss of 3.41% for the 10 Year U.S. Treasury Bond.

3) The **third scenario** assumes a gradual rise in inflation to 6% and then a gradual fall back to its long-term rate of 3%. Under this scenario, TIPS provide an annual return of 2.56% versus an annual loss of 0.91% for the 10 Year U.S. Treasury Bond.

4) Our **fourth scenario** assumes inflation remains constant at a 1% annual rate for the entire ten years. This scenario, with a very long-term period of low inflation, is known as an "L Shaped" recovery, reminiscent of the performance of the Japanese economy over the past two decades. Under this scenario, the 10 Year Treasury Bond provides the higher annual return of 3.5% versus the 2.2% annual return of TIPS In this case, the 10 Year Treasury outperforms since the recent rise in long-term government bond yields has not yet been accompanied by a short-term rise in the CPI.

Table 1 summarizes our findings. Namely, TIPS outperform U.S. Treasuries under most scenarios since they generate increased interest and principal payments as the CPI rises. In contrast, conventional U.S. Treasury Bonds have fixed interest and principal payments that are valued less by the market as interest rates rise. Of course if a falling CPI or deflation persisted over the entire 10-year time horizon then conventional U.S. Treasuries would outperform TIPS. In all cases, the nominal and risk adjusted returns to a buy and hold strategy are not particularly appealing.

Table 1: Projected TIPS and U.S. Treasury Bond Returns

Economic Scenario and Corresponding Change in Interest Rates	TIPS Return	Conventional T-Bond Return
1) Unexpected Near-Term Spike in Interest Rates	2.84%	-3.57%
2) Gradual, Continuous Rise in Interest Rates	2.80%	-3.41%
3) Gradual Rise then Gradual Fall in Interest Rates	2.56%	-0.91%
4) No Change in Interest Rates - "L Shaped" Recovery	2.20%	3.5%

Tactical Trading in TIPS

Nimble traders and hedge funds may be able to do better than a simple buy and hold strategy. For example, if a trader were to buy TIPS while inflation is at its current 1% level and sell them in one year after the CPI spiked to 6%, an annual return of 5.2% would be achieved. Additionally, the TIP oriented ETF (symbol TIP) has varied over the past 52 weeks in a price range from $84 to $109. A perfect market timer who was able to buy at the bottom and sell at the top would have realized a return of almost 30%. The returns to these strategies are far from certain given the continued market volatility and inherent difficulty in market timing strategies.

TIPS tend to be thinly traded with an average dollar volume across all issues of $9 billion per day. This figure is dramatically smaller than the $500+ billion traded per day in traditional U.S. Treasuries. Hence, there may be liquidity issues related to trading TIPS during times of market distress. Some hedge funds utilize leveraged spread trades, going long TIPS and short U.S. Treasuries. These leveraged strategies offer the prospect of double-digit returns, but also face material risk in the event of a “flight to quality” scenario, such as those experienced during the most recent bear market or in the 1998 Long Term Capital Management debacle.

The scenarios contemplated by this memo assume that real interest rates are stable. Under this assumption, TIPS should trade near their accrued principal value. But, as most recently evidenced by surging interest rates on 10-year Treasury bonds with no commensurate increase in inflation, real interest rates have been relatively unstable, and TIPS prices have fluctuated substantially. TIPS are inherently more sensitive to changes in real interest rates than conventional Treasury securities because their more “back-loaded” payment structure results in a longer duration. Although this volatility may create additional opportunities for tactical traders, it could be potentially unnerving to buy and hold investors who buy TIPS in order to obtain their added degree of perceived safety.

Conclusion

We believe that significant long-term inflation remains an important risk. TIPS are a natural vehicle for implementing this viewpoint since their cash flows increase as inflation rises. However, the nominal return for buy and hold TIPS oriented strategies are not attractive at this current time, providing returns of approximately 3% per annum under a 6% CPI forecast. Higher returns may be achieved with tactical trading around TIPS, but until a sharp increase in short-term inflation becomes likely, we believe our current lineup of investment ideas provides a superior risk adjusted return. We are currently researching a range of investments that are expected to outperform in an aggressive inflationary environment and will bring these ideas to our clients at the appropriate time.

As always, we close by thanking you for your loyalty and support. We at MDE consider our relationship with our clients a symbiotic partnership. We realize our sole mission as a firm is to add value to our clients in any way we can.