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CREDIT MARKETS

Treasury's TIPS May Be Popular, But That May Not Mean Profitable

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Rising prices from the gasoline pump to the supermarket checkout have made Treasury Inflation-Protected Securities a popular investment lately.


But popular may not mean profitable, some analysts warn. TIPS -- which are securities issued by the Treasury Department that guarantee a return that beats the inflation rate -- have grown more expensive compared with Treasury notes than they have been in more than six years, they note.

In other words, it's going to take more inflation, and a lot more than it would have taken six or 12 months ago, to make these hot securities perform better than plain old Treasury bonds.

The concerns about TIPS come as the Treasury plans to vastly expand its TIPS selling program -- adding five-year and 20-year securities to the current 10-year notes later this year -- and as investors big and small are racing to buy TIPS, often through mutual funds and retirement accounts.

Some investors are willing to bet on TIPS, especially with oil hovering near \$40 a barrel and the economy continuing to add new jobs. They view TIPS as an insurance policy against runaway inflation. And while the insurance has clearly gotten more expensive, that doesn't mean it isn't needed, they reason. After all, the consumer-price index -- the most widely followed inflation measure -- moved up to 2.3% on a year-over-year basis in April, up from 1.9% in January.

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OTHER RESOURCES

[See real-time commentary](#)¹ covering releases, events, and flows affecting the Treasury market, from [Briefing.com](#)².

AUCTION RESULTS

Here are the results of yesterday's Treasury auctions. All bids are awarded at a single price at the market-clearing yield. Rates are determined by the difference between that price and the face value.

12-Day Cash Management Bills

Applications	\$73,860,000,000
Accepted bids	\$30,000,175,000
Accepted noncompetitively	\$45
Bids at market-clearing yld accepted	50.66%
Auction price (Rate)	99.968 (0.965%)
Coupon equivalent	0.974%
Cusip number	912795QP9

The bills are dated June 3 and mature June 15, 2004.

Four-Week Bills

Applications	\$53,512,482,000
Accepted bids	\$24,000,392,000
Accepted noncompetitively	\$43,867,000
Accepted frgn noncomp	\$0
Auction price (Rate)	99.927 (0.940%)
Coupon equivalent	0.952%

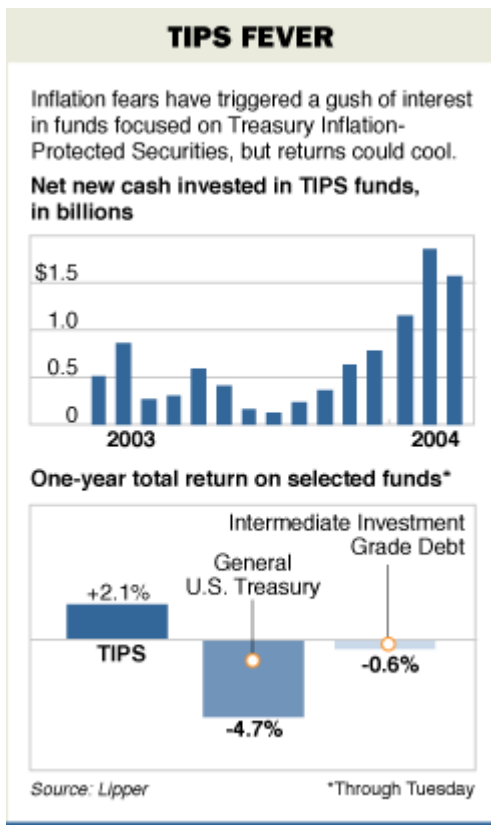
But investors should remember one fundamental fact: TIPS, like most bonds, are sensitive to interest rates. That means the value of TIPS will likely fall along with other bonds when interest rates rise. While TIPS provide insurance against rising inflation -- because their principal is adjusted for changes in the CPI -- they don't provide insurance against rising rates.

Bids at market-clearing yld accepted	73.86%
Cusip number	912795QR5

The bills are dated June 3 and mature July 1, 2004.

TIPS are likely "to perform poorly on an absolute basis" over the next few months as interest rates move higher, says Joseph Shatz, senior government bond strategist at Merrill Lynch. Last month, Merrill wrote in a report that 10-year TIPS would lose between 1.6% and 4.4% over the next 12 months if the Federal Reserve raised its target short-term rate by one percentage point. The smallest loss assumed 4% inflation while the largest assumed tame inflation of 1%.

Overall, the Treasury is expected to sell an estimated \$65 billion in TIPS this year, more than double the \$26 billion it sold in 2003, according to Barclays Capital, a large TIPS dealer. In July alone, the Treasury is expected to sell about \$20 billion in new TIPS, including a new 20-year TIPS issue. Prices may need to decline somewhat in order for all the new TIPS to find a home.



With that looming supply and with many expecting the Fed to raise short-term rates at the end of this month, TIPS prices "are rich at these levels," says John Roberts, managing director at Barclays.

TIPS have had such a strong run that they have grown "expensive," says Bill Tedford, director of fixed-income strategy at Stephens Capital Management, which sold its TIPS investments in late 2002. "Even though inflationary expectations have risen, the real yield isn't high enough yet" on TIPS to start buying. Mr. Tedford won't be interested again until the 10-year TIPS yield rises to 3% from its current level of about 2%.

TIPS-focused mutual funds have rung up eye-catching gains in recent years, posting average annual gains of 8.7% over the past three years and nearly 9% over the past five years, according to fund-tracker Lipper Inc. Those returns beat both the Standard & Poor's 500-Stock Index and the nation's average taxable bond fund, which average an annual loss of 1.5% and an average gain of 5.2%, respectively over the past five years.

Given those gains and rising inflation fears, investors have flocked to TIPS funds, which took in more than \$11 billion in new money in 2002 and 2003 combined, according to Lipper's tally. A record \$4.5 billion flowed into the funds in the first quarter, and more than a dozen TIPS-focused mutual funds have been launched since the start of 2002. Pension funds have also moved into the market on the belief that investments tied to inflation better match their liabilities, which often are also tied to rising prices.

A gush of new mutual-fund offerings and money flowing in a niche category is typically a red flag

that interest in that area may be overdone, a situation last seen with technology and growth funds in the late 1990s. While TIPS are less volatile than stocks, some worry recent investors in these funds who expect more heady gains are likely due for disappointment.

Indeed, if the Fed moves quickly to raise rates in an effort to stave off inflation, TIPS will suffer a double whammy because rate rises hurt fixed-income investments generally and because the inflation premium may whittle away if it looks like a vigilant Fed will stamp out inflation.

In coming weeks, TIPS will likely take their cue from oil prices, gaining versus regular Treasuries when crude prices rise and falling when they drop, says Alex Li, an interest-rate strategist at Credit Suisse First Boston. New inflation data also will have an impact, especially on shorter-term TIPS.

Late yesterday, the 10-year TIPS yielded 2%, about 2.73 percentage points below the 10-year Treasury note. That gap -- which many pros call the "breakeven inflation rate" -- is the annual level of inflation needed over the next decade for TIPS to match regular Treasuries.

The breakeven rate hasn't been as high as it is now since 1997. That gives TIPS investors "a very high hurdle," wrote Mr. Li in a recent report. "It assumes that inflation moves significantly above the Fed's long-term comfort zone and that the Fed can't control it."

Even TIPS fans have concerns. TIPS are an "extremely useful innovation," says Eric Jacobson, a senior fund analyst at Morningstar Inc. But he worries "investors are looking at the funds' past returns and don't know much about how the TIPS market works."

Indeed, with about \$200 billion in assets, the TIPS market is still just a tiny sliver of the overall bond market. Even the pros running hot-selling TIPS funds admit the bonds' brief history make it tough to know how the bonds will react as interest and inflation rates shift.

TIPS funds can be more volatile than standard Treasuries that don't offer inflation protection. The average TIPS fund tumbled more than 4.6% on average in April, compared with a 3.9% fall for general Treasury funds, for example. Despite their low-risk billing, TIPS have suffered other monthly losses of that magnitude, Morningstar's Mr. Jacobson notes.

Some fund managers are bracing for more choppy water. Daniel Shackelford, manager of the \$52.2 million **T. Rowe Price Inflation Protected Bond Fund**, says TIPS aren't as attractive as they were 18 months ago. He has lessened his TIPS exposure by buying a modest stake in fixed-rate Treasuries. And Robert Arnott, manager of the \$1.8 billion **Pimco All Asset Fund**, has gradually cut his fund's position in longer-maturity TIPS from more than 40% of assets 18 months ago to about 10% today. The fund still has a significant position in shorter-term TIPS.

Yesterday's Treasury Trading

Treasury prices fell -- declining for a third straight session -- on bearish sentiment ahead of tomorrow's report by the Labor Department on monthly payrolls growth.

Investors expect the data to shed light on how rapidly the Federal Reserve might raise short-term rates this year.

At 4 p.m., the benchmark 10-year note was down 6/32 point, or \$1.875 per \$1,000 face value, at

100 4/32. Its yield rose to 4.734% from 4.710% Tuesday, as yields move inversely to prices. The 30-year bond was down 7/32 point at 99 11/32 to yield 5.422%, up from 5.406% Tuesday.

Emerging-Markets Debt

Trading in Argentine bonds suggested that investors are holding out for better terms under the nation's planned debt restructuring, analysts said. A global issue due 2008 fell about a point to 30 bid, although Argentina's spread within the J.P. Morgan Emerging Markets Bond Index Plus was little changed at 46.88 percentage points over U.S. Treasurys.

--Michael Mackenzie and Angela Pruitt contributed to this article.

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