Inflation-linked bonds give retirees diversification and hedge against inflation

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(Photo: Getty Images/iStockphoto)

If you believe the economy will soon grow faster and that inflation will accelerate, then you might want to consider investing a not insignificant portion of your portfolio in Treasury Inflation-Protected Securities or TIPS.

In fact, individuals and institutions should allocate about 20% of their portfolios to what are also referred to as inflation-linked bonds, according to the authors of a report published in IMCA's Journal of Investment Consulting.

And there four reasons for doing so according to Kurtay Ogunc, a finance instructor at Louisiana State University and Asli Ogunc, a professor at Texas A&M University-Commerce, the authors of *Inflation-Linked Bonds for Strategic Asset Allocation (https://ssrn.com/abstract=2913103)*.

Low and sometimes negative correlations with major asset classes

For starters, TIPS don't move in the same direction as stocks and traditional bonds. That's part of what makes them a good investment. In a well-diversified portfolio, you want some assets that rise in value when others are falling.

Asli Ogunc, a professor at Texas A&M University-Commerce, and Kurtay Ogunc, a finance instructor at Louisiana State University are the authors of "Inflation-Linked Bonds for Strategic Asset Allocation" *(Photo: handout)*

"Because the market prices of inflation-linked bonds do not react to changes in expected inflation, their returns do not correlate with those of stocks and nominal bonds, making them an excellent diversifying tool for traditional portfolios," wrote Ogunc and Ogunc.

"The correlations with other investments are very attractive," says Lane Steinberger, the chief investment officer of Redwood Wealth Management. "I tend to zero in on how they correlate with other fixed-income investments and include them with Treasuries, corporates and foreign bonds. Thus, I look at the allocation as a percentage of the bond portfolio as opposed to the overall portfolio."

Lane Steinberger CFA, CFP® Redwood Wealth Management Partner, Chief Investment Officer *(Photo: Lane Steinberger)*

Expectation for higher probabilities of inflation surprises

TIPS are also designed to protect investors against inflation in ways that typical bonds don't. Here's how: "The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index (CPI)," according to the Treasury Department. "When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater." Read Treasury Inflation-Protected Securities (TIPS) (https://www.treasurydirect.gov/indiv/products/prod_tips_glance.htm).

So, if inflation is rising, as it is now – it rose 2.5% for the 12 months ending January – TIPS become a good investment provided the return is greater than what's called the breakeven inflation rate. That rate is the difference between the nominal yield on a 10-year Treasury (2.35%) and the 10-year TIPS yield (0.34%). Right now, the breakeven rate is 2.01%. So, if you think inflation will be higher than 2.01% – the Federal Reserve's current target rate for inflation – over the next 10 years, TIPS would be a good investment.

"I believe that inflation-indexed bonds are one, a good representation of the risk-less asset for long-term individual investors who expect to consume in real dollars and two, an excellent substitute for nominal Treasuries if you expect inflation to be at the breakeven rate implied by the difference between TIPS and nominal yields," says Larry Siegel, the research director of the Research Foundation of CFA Institute. "If you expect inflation to run faster than breakeven, TIPS are the better investment although the principle of diversification says you should have both – because you could be wrong."

His advice: If you're supposed to allocate 40% of your portfolio to fixed-income securities, invest one-half in traditional bonds and the other half in TIPS and other inflation-indexed or real assets.

Larry Siegel Research Director of the Research Foundation of CFA Institute *(Photo: handout)*

Of note, the current rate of inflation is substantially below the 3.77% average since the end of the World War II but it's above its 10-year moving average, now at 1.77%, according to Jill Mislinski, research director at Advisor Perspectives.

For his part, Brad McMillan, the chief investment officer at Commonwealth Financial Network, says the best time to buy TIPS is before inflation starts to rise. "Right now, though, inflation has just hit five-year highs, and is on the minds of many investors," he says. "That protection might be more costly, and less necessary, than it was a year ago. That said, inflation is still quite low by historical standards, and for longer time horizons the argument continues to make sense."

Top TIPS investments

TOP TIPS INVESTMENTS	
Investment/symbol	Investment rationale
Schwab US TIPS ETF (SCHP)	Provides broad market exposure to TIPS at a low price. It tracks the Bloomberg Barclays U.S. TIPS Index, a market-cap-weighted index that covers TIPS issued by the U.S. government.
Vanguard Short-Term Inflation-Protected Securities ETF (VTIP)	One of the cheapest funds providing exposure to the short-end of the TIPS market
Vanguard Inflation-Protected Securities (VIPSX) and Vanguard Inflation-Protected Securities Fund Admiral Shares (VAIPX)	Excellent choice for investors looking for a pure-play inflation hedge. Its fees are among the lowest for open-end mutual funds and exchange-traded funds.
iShares 0-5 Year TIPS Bond (STIP)	Seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds with remaining maturities of less than five years.
iShares TIPS Bond ETF (TIP)	Seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds.

Source: Morningstar, Steve Osterink, Lane Steinberger, company reports

Robust risk/return profiles of TIPS

In their paper, Ogunc and Ogunc showed that adding TIPS to portfolios improved risk-adjusted performance over various time periods. In fact, portfolios with TIPS had risk-adjusted annualized returns of 8.2%.

An inherent need to match liabilities that increase in value as inflation rises

Some financial advisers recommend that investors match their current assets to their future living expenses. And TIPS are among those assets that can be used to fund future liabilities that increase in value as inflation rises – such as health care.

In fact, Kurtay Ogunc says retirees should invest even more than 20% of their portfolio in TIPS given that investors receive a return that keeps pace with inflation, one of the big risks investors face in retirement.

“It’s not something the paper is advocating explicitly, but given the nature of retirement years going forward – higher inflation and longevity risks – I would put about 30 to 35% (in TIPS),” he says,

To be fair, TIPS, which tracks the consumer price index or CPI, are not a perfect match for future expenses. For instance, housing (owner-equivalent rents) represents a large chunk of CPI. And that expense might not matter to a retired investor with a paid-off house compared to the food and energy component, says Steinberger.

Two sides to every coin

Of course, there are downsides to investing in TIPs. “If none of the inflation-surprise or higher-inflation scenarios play out, then investors are stuck with a low-yield asset that will underperform nominal assets,” says Steven Mula, the chief investment officer at JJ Burns & Co. “As the authors note, a deflationary scenario would be very unpleasant.”

Brad McMillan, the chief investment officer at Commonwealth Financial Network *(Photo: Cheryl Clegg)*

That's true. But that's why experts also suggest hedging against that possibility by investing in nominal bonds as well, and switching out of TIPS should inflation not rise above the break-even rate.

Others also say investing 15% to 25% or even more in TIPS might not be prudent. "I like the idea of using TIPS, but a 20% allocation seems high – even for moderate to conservative investor," says Steve Osterink, Jr., the chief investment officer of Advisory Alpha. "We research over 80 distinct asset classes for our diversified strategies and are very cautious when allocating such a large allocation to any individual market segment."

Robert Powell is editor of Retirement Weekly, contributes regularly to USA TODAY, The Wall Street Journal, TheStreet and MarketWatch. Got questions about money? Email Bob at rpowell@allthingsretirement.com.

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