NEWPERSPECTIVES

Commentary from New Century Advisors
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Why Does my TIPS ETF Have a Negative Return?

- **Misunderstood asset class doesn't always perform as people expect**
- **Separate account investors have more options for inflation protection**

Misunderstood

Inflation, you may have noticed, is rising. Year over year CPI hit 2.5% in April, up from 1.6% last summer and basically *zero* back in 2015, and it is likely to print at an even faster rate in the months ahead. That has garnered the attention of retail and institutional investors alike, and they've looked to the $1.2trn TIPS market for some answers. The problem is, TIPS (Treasury Inflation Protected Securities) don't always give investors the answers they're looking for.

In a recent podcast between NCA's own Com Crocker and Monthly Dirtcast host Jared Dillian, Jared referred to TIPS as, "possibly the most misunderstood asset class on the planet." Hyperbole aside, there is no question that TIPS, which are 9% of the deep and liquid U.S. Treasury market, remain remarkably poorly understood, particularly for a market of its size.

Take the last six months as an example. With passage of the Republican tax plan in late December, investors poured money into TIPS with the expectations that cutting taxes would lead to more spending and higher inflation. Spurred on further by rising oil prices and a very strong January CPI report, investors kept piling in, adding $2bn to TIPS ETFs in January and February, or about twice the rate of 2017.

But a funny thing happened. Despite rising inflation expectations and even a pickup in actual inflation, TIPS investors lost money in early 2018. TIPS returned -0.88% in January and -1.08% in February. The good news is that TIPS outperformed nominal Treasury bonds – that is, U.S. government debt NOT linked to inflation – over the same period. Comparable Treasuries sold off by 2.62% in the first two months of the year, or by 67 basis points more than TIPS. So TIPS outperformed nominal Treasuries in a rising-inflation environment, but they still ***lost money***. That was unsatisfactory to some investors, and sellers emerged in March, with some $500mm flowing out of TIPS ETFs. As of the end of April they were still down 0.91% on the year. They've continued to outperform comparable Treasuries, however, which are down 2.5%.

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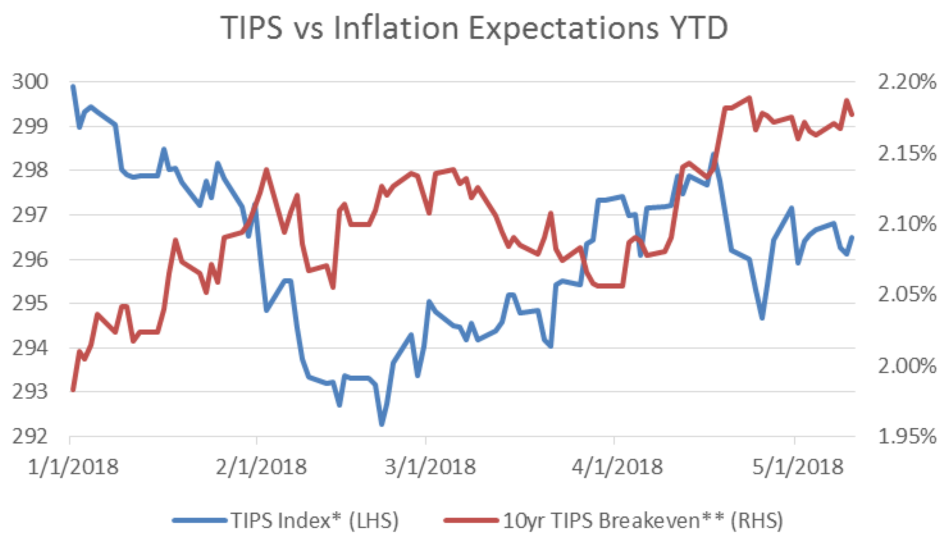

*Bloomberg Barclays US Govt Inflation Linked Bonds Index
**Spread between 10yr TIPS and 10yr Nominal Treasury

What investors must understand about TIPS is that while their principal is linked to inflation, growing (and sometimes shrinking) every month based on the most recent CPI print, they are still a *bond*. As such, their market values *also* rise and fall with movements in *interest rates*. As interest rates rise, prices fall, and vice versa. And as you're no doubt aware, lately interest rates have risen. 10yr Treasuries currently yield 2.96% (as of 5/11/18). That's up 55 basis points since the end of 2017, and 1.60% since their 2016 lows. Yields on TIPS have also risen, though by less than nominal Treasuries, thus outperforming over the same period.

Options

Retail investors who want the inflation protection of owning TIPS but are wary of interest rate risk do have some options, but they are limited. One is to simply own TIPS with shorter maturities as these are less impacted by interest rate fluctuations. TIPS securities have maturity dates spanning the next 30yrs, and longer-dated issues carry more interest rate risk. While most TIPS ETFs represent the entire TIPS yields curve, there is a growing cohort that invests only in TIPS maturing within the next 5yrs. The 1-5yr TIPS index is actually up on the year (a scant 0.07%, but not much is positive out there.) Other options are to invest in both TIPS and an inverse Nominal Treasury fund, thereby offsetting the duration risk, but the fees start to add up, and matching the interest risk between the two funds is a bit of a challenge. There have been a few ETFs and ETNs which have tried to do this for investors, leaving them exposed only to the 'breakeven' spread between TIPS and nominals, so named because that is the inflation level above which the TIPS holder will win out. But they are also expensive (30 to as much as 70 bps in fees!), and have struggled to gain any traction.

Institutional investors have it a little better as they have more resources and options to choose from. A hedge fund has the option of selling securities they don't own and thus can put on a pure breakeven trade themselves, buying TIPS and selling nominal Treasuries against them. They can match the maturity and duration profile precisely if they choose. Even so-called 'real money' investors, pensions and the like, who can only sell what they have, will likely have enough nominal Treasury exposure in their portfolio that they can replace some of it with TIPS, effectively going long the breakeven. Or they can craft tailor-made solutions with an active manager to create portfolios that are highly sensitive to inflation, even with attractive running yields. At a minimum, one trusts that institutional investors understand TIPS well enough to know what happens to their value as rates rise.

It is worth considering, of course, what happens when rates go *down*. In that case, TIPS should benefit from falling yields and see their prices rise. And in the inverse of the rising inflation/rising rate scenario, if rates are falling because inflation is falling, they might lag nominals in the process. But as global synchronized growth, one of the major themes from 2017, continues to soften in 2018, just as tight resource and labor markets put upward pressure on inflation, chatter is picking up about yet another possibility: the dreaded *stagflation*. In such an environment, an outright long position in TIPS may be just the thing your portfolio needs.

For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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