TREASURY BONDS FOR INFLATIONARY TIMES

The smell of rising inflation is in the wind, and some investors are taking a second look at a type of investment they've generally ignored during these low-inflation times: inflation-adjusted government bonds.

Conventional bonds and other fixed-instrument investments such as certificates of deposit are vulnerable to the risk of inflation, which eats into their buying power over time. Inflation-adjusted bonds offer the advantage of increased returns when inflation occurs.

Inflation has been low in recent years, but some experts believe it may not be for long. In March 2003, the Consumer Price Index rose only 1.7 percent over the previous 12 months. But the CPI for the first three months of 2004 jumped at an annual rate of nearly five percent.

Investors concerned about inflation, particularly retirees, might consider two types of inflation-adjusted bonds issued by the federal government: Treasury Inflation Protected Securities, or TIPS (technically a note, not a bond), and Series I savings bonds, known as I-bonds. Each operates a bit differently.

I-bonds come in two parts. When the federal government issues new I-bonds it announces a minimum fixed rate for that particular issue. That rate remains in effect for the life of the bond—up to 30 years. The government adjusts that rate every six months when it issues new bonds.

In addition to the underlying fixed rate, the government tacks on an inflation-adjusted interest rate based on the Consumer Price Index for the previous six months. This rate is readjusted every six months over the life of the bond and is what provides the bondholder with some inflation protection.

TIPS are calculated differently. The government auctions new TIPS every three months and a fixed interest rate is determined at that time. Every six months an inflation adjustment is made

pegged to changes in the CPI. But unlike I-bonds, the adjustment is made to the principal, not the interest rate.

Say you invest $10,000 in TIPS with a fixed rate of 2 percent and inflation rises 1.5 percent during the next six months. The principal is increased to $10,150 (1.5 percent of $10,000 is $150) and the 2-percent interest rate is applied to the $10,150 principal for the next six months, raising the bond's effective yield.

The federal government currently issues TIPS only in ten-year maturities with a minimum investment of $1,000. I-bonds are sold at face value ranging from $50 to $10,000 and they accrue interest for up to 30 years.

Both types of securities are exempt from state and local tax, but not federal income tax. With TIPS, the semiannual payments are subject to annual ordinary income taxes. But that includes the inflation-adjusted increase in the principal even though you don't actually receive that increase as a payout until the bond matures or you sell it. In essence, you pay tax on "phantom income."

With I-bonds, you don't owe any tax on the accruing interest until you cash in the bond, and if you use the interest for qualified college expenses, you may not have to pay any tax on the interest at all. This is why I-bonds may be best for taxable accounts and TIPS for tax-deferred accounts.

You can buy TIPS and I-bonds directly, but only TIPS can be bought through mutual funds. You can buy all the TIPS you want, but individual investors can buy no more than $30,000 worth of paper I-bonds and another $30,000 in electronic I-bonds in a calendar year. You also have to hold the bonds at least 12 months before cashing them in, and if you cash them in within the first five years, you lose three months' worth of interest.

While these securities are government-guaranteed, they are not risk free. TIPs, like other Treasury or corporate bonds, can lose principal should interest rates rise and you sell the bond before it matures. If you hold it to maturity, however, you will receive the inflation-adjusted principal or the par value of the bond, whichever is greater.

You can't lose principal with I-bonds, but along with TIPs they carry another risk. The fixed interest rate on both of these bonds is less than what you would receive for comparable non-indexed Treasury bonds. The interest-rate gap between non-indexed and inflation-indexed bonds reflects the expected rate of inflation over the life of the bond. If inflation comes in lower than anticipated, investors would have done better with regular bonds.

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