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Are TIPS a Good Inflation Hedge? It depends....

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Are TIPS a Good Inflation Hedge? It depends....

The US Treasury and Federal Reserve have provided an unprecedented amount of stimulus to deal with the current financial crisis. A common concern is that rising inflation is an inevitable outcome once the economy recovers. The Treasury Inflation Protected Securities (TIPS) market has attracted a lot of interest as a possible hedge against future inflation. In our opinion, TIPS are not a good inflation hedge on a standalone basis since they are subject to interest rate risk. However, versus other fixed income sectors, we feel TIPS can be an attractive hedge option. Further, for existing fixed income investors, TIPS work best as an inflation hedge if their purchase is paired with a sale of a similar duration non-TIPS fixed income security to help neutralize duration or interest rate risk. For non-fixed income investors, TIPS are not necessarily an inflation hedge panacea.

Background and Basics

TIPS were first issued by the US Treasury in 1997 and currently there are around \$500 billion outstanding. Like other fixed income securities, TIPS have a principal or face value as well as a coupon rate which determines periodic coupon payments. The primary feature of TIPS is that the principal amount changes with the underlying rate of inflation. The coupon rate on the security is fixed, so as the principal value changes with inflation, the dollar amount of the coupon being paid to the owner of the TIPS fluctuates. TIPS are referenced to an inflation index that includes food and energy, which is a source of volatility with the commodity price swings we have witnessed over the past few years.

Inflation expectations can be derived by comparing the yield of a Treasury security with similar maturity TIPS. The difference is referred to as the breakeven inflation rate, or the rate of inflation that will make the return of the securities equal (see table below). From a long-term perspective, if you believe future inflation will be higher than the breakeven rate, then you would prefer to own TIPS relative to nominal Treasury, and vice versa.

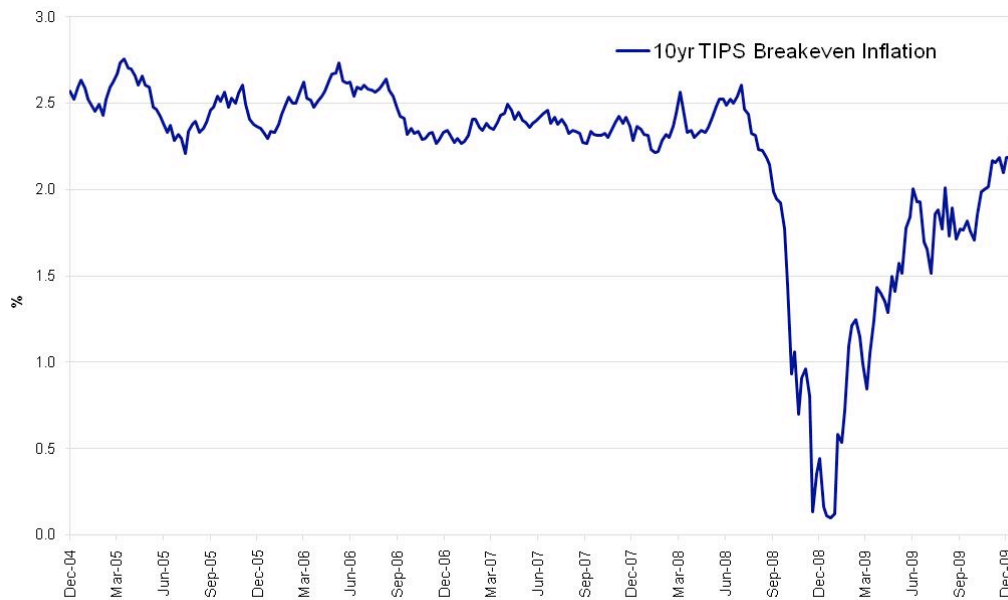
Inflation Expectations implied by TIPS

	Yield
10 Year Treasury	3.85%
10 Year Treasury Inflation Protected Security	1.45%
Breakeven Inflation Rate	2.40%

Source: Bloomberg

Inflation expectations observed in the TIPS market are constantly changing with the outlook for the economy and inflation, as well as several other factors. Rising inflation expectations are good for holders of TIPS relative to Treasuries, as the price of TIPS will outperform the Treasury security.

The graph below shows inflation expectations for the next 10 years as implied by the TIPS market. Prior to the crisis, the normal range was around 2.5%. During the height of the crisis in late 2008, expected inflation for the next 10 years was near 0%. This reflected the seriousness of the economic downturn as well as difficult liquidity conditions after the bankruptcy of Lehman Brothers. Since then, the economy has begun healing and the impact of Lehman has faded. TIPS have performed very well in 2009, with inflation expectations steadily rising and now implying around 2.40% inflation over the next 10 years.



Source: Bloomberg

Interest Rate Risk Reduces Appeal of TIPS

Inflationary environments are associated with rising Treasury yields and declining Treasury prices. Yields available today are exceptionally low and vulnerable to any rise in inflation or inflation expectations. The current outlook for inflation is highly uncertain, balancing the economic slack evidenced by 10% unemployment with massive government stimulus, which raises the risk of future inflation. We feel the economy is healing and expect moderate growth in 2010. Interest rates are likely to rise in this scenario with the Fed beginning to remove some of the additional liquidity they are providing to the financial system.

Rising interest rates significantly decreases the attractiveness of TIPS on an absolute return basis. The Barclays US TIPS Index has a duration, or interest rate sensitivity, of 7.6 years. If interest rates were to rise 1% due to increasing concern over inflation, the price of the TIPS index would decline roughly 7.6%. The prospect of solidly negative returns in an inflationary environment doesn't satisfy expectations as an inflation hedge.

Using TIPS as an Inflation Hedge

In our opinion, the best way to use TIPS as an inflation hedge is by also selling Treasuries or other high quality fixed income securities, reducing the sensitivity to rising interest rates. By selling other bonds, an exposure is created that benefits from high realized inflation and rising inflation expectations. If interest rates rise significantly due to inflation fears, we believe TIPS will significantly outperform other fixed income instruments.

Barclays Capital¹ recently studied the effectiveness of various asset classes as inflation hedges by comparing the return of the asset with the realized rate of inflation. Commodities generally were the best inflation hedge in this study. On a standalone basis, TIPS were not an efficient hedge, mainly due to the interest rate risk of TIPS. Buying TIPS and selling Treasuries to gain exposure to rising inflation expectations (TIPS breakeven inflation) was shown to be an efficient hedge and the way we recommend using TIPS.

Active Management

We are currently including TIPS in client portfolios as we believe they represent relatively cheap insurance on rising inflation. Just as with other asset classes, we feel it is important to actively manage the TIPS exposure in portfolios, and not constrain the exposure to an ETF or similar index-like vehicle. Opportunities to add value in a TIPS portfolio come from managing exposure to interest rate risk and yield curve structure, as well as actively trading between the TIPS market and Treasury market. The market is constantly adjusting to new information, and having the knowledge and flexibility to adjust portfolios to add value is important in fully utilizing the assets allocated to the TIPS market.

¹Source: *Barclays Capital Market Strategy Americas July 3, 2009*



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