

Understanding Inflation-Protected Bonds



Inflation can eat away at your investment returns and cut into your purchasing power, whether you're saving to buy a house in a few years or for retirement further down the road. But many investors have overlooked the impact of inflation when building a diversified portfolio. Inflation-protected bonds, which were specifically designed to protect against rising consumer prices, are an effective way to address this problem. And Treasury Inflation-Protected Securities, known as TIPS, are one of the most attractive members of this asset class.

What is inflation and why should I be concerned about it?

Inflation is an increase in the price of goods and services. In the U.S., a widely accepted measurement is the Consumer Price Index (CPI), which is published monthly by the Bureau of Labor Statistics. As the chart at right shows, based on the CPI, prices have risen steadily in the U.S. since the end of World War II.

In effect, inflation shrinks the value of your money. The dollar you invest today will be worth less tomorrow. That's why inflation poses such a serious threat to investors. And for bondholders it is a particular concern, since it can erode the purchasing power of future interest and principal payments.

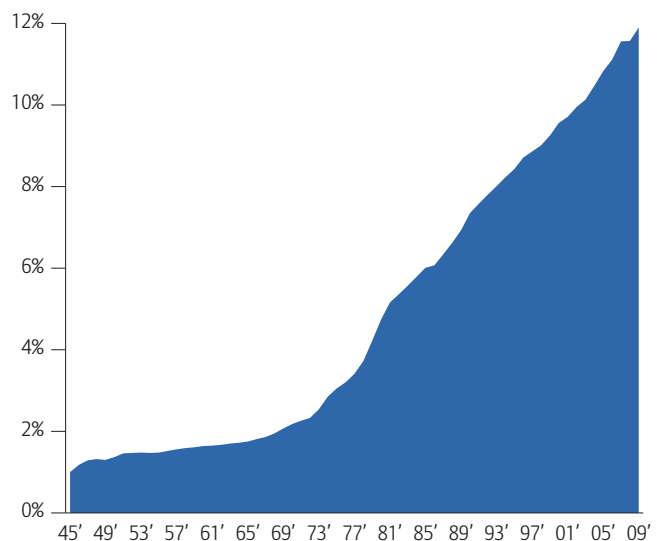
How do TIPS and other inflation-protected bonds work?

TIPS are inflation-protected bonds (IPBs) that are issued by the U.S. Treasury. Like other IPBs, their face value is adjusted in step with changes in the rate of inflation. The Treasury then pays interest on the adjusted face value of the bond, creating a gradually rising stream of interest payments as long as inflation continues to rise. At maturity, a TIPS investor will receive the original face value plus the sum of all the inflation adjustments since the bond was issued.

It works like this: Suppose you invest \$1,000 in a new 10-year TIPS with a 2% coupon rate. If inflation is 3% over the next year, the face value will be changed to \$1,030 and the annual interest payment would be \$20.60, or 2% (the coupon rate) of the adjusted principal. If inflation climbs 3% again the following year, the principal would be adjusted to \$1,060.90 and the interest payment would be \$21.22. And so on.

The Rising Cost of a Dollar

Based on the CPI, what one dollar could buy in 1945 would now cost \$11.90.

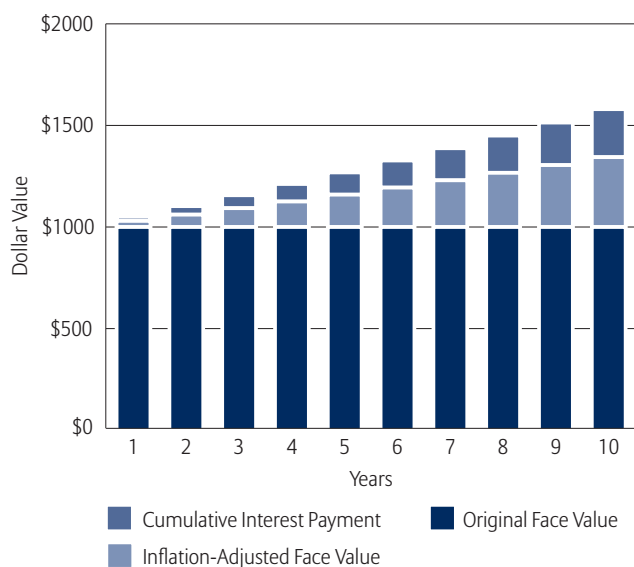


Source: U.S. Bureau of Labor Statistics, as of 12/31/09
This chart is not indicative of the past or future performance of any Allianz Global Investors product.

As a result, TIPS and other IPBs offer what is known as a “real” rate of return—the actual return of an investment after inflation is taken into account. A traditional bond, on the other hand, offers a “nominal” return. It maintains a fixed face value until maturity, with no adjustments for inflation. For example, if you're receiving a 5% return on a traditional bond and inflation is rising at 3%, your “real” return is actually only 2%.

How TIPS Grow in Value

TIPS help guard against inflation by adjusting their face value with changes in the rate of inflation. Interest is then paid on the adjusted face value of the bond.



Source: Allianz Global Investors

This chart is for illustrative purposes only and is not based on any statistical information and is not indicative of returns on any Allianz Global Investors product. Assumes 2% annual coupon and 3% annual rate of inflation.

What are some other advantages of investing in TIPS?

- TIPS can be an effective portfolio diversification tool. Because TIPS have a low correlation with other types of investments they have the potential to reduce overall portfolio volatility.
- TIPS, like other Treasury bonds, are guaranteed by the U.S. government. (However, a fund that invests in them does not carry such a guarantee.)
- TIPS offer the government's assurance that investors will never receive less than the original face value of the bond at maturity, even in the unlikely event of deflation during the life of the bond (when prices actually fall).

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A Word About Risks: Diversification does not ensure against loss. In an environment where interest rates may trend upward, rising rates will negatively impact most bond funds, and fixed income securities held by a fund are likely to decrease in value. Bond funds and individual bonds with a longer duration (a measure of the expected life of a security) tend to be more sensitive to changes in interest rates, usually making them more volatile than securities with shorter durations. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. The guarantees apply to the timely payment of interest and principal on the underlying Treasuries. US Government bonds and Treasury bills are guaranteed by the U.S. Government and, if held to maturity, offer a fixed rate of return and fixed principal value.

The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Department of Labor Statistics. There can be no guarantee that the CPI or other indexes will reflect the exact level of inflation at any given time. For information about the Allianz Global Investors Managed Accounts, contact your financial advisor. Managed accounts are available through Allianz Global Investors Managed Accounts LLC, 1345 Avenue of the Americas, New York, NY 10105-4800. The funds are distributed by Allianz Global Investors Distributors LLC, 1345 Avenue of the Americas, New York, NY 10105-4800, www.allianzinvestors.com.

How does the risk on TIPS and IPBs compare with other bond investments?

TIPS do not carry credit risk because of their government guarantee. However, like all other bonds and IPBs, TIPS are subject to interest rate risk. TIPS should do better in a rising interest rate environment than conventional Treasury bonds because their inflation adjustments provide better price protection, but that is only when rates are rising as a result of increasing inflation. If rates were to rise in an environment of low or no inflation, TIPS' prices could decline.

Investors who purchase individual TIPS or other IPBs should be aware of a phenomenon called "phantom income." This refers to the fact that the inflation adjustment to an IPB is taxable in the year it occurs even though you won't receive this money until the bond matures. This does not apply to a mutual fund, however, because a fund pays out both interest income and the income from principal adjustments to investors monthly. You pay the federal income tax, of course, but you're also receiving the income you're paying it on.

Investors who own TIPS through a mutual fund should also be aware that the fund may perform differently than the underlying bonds. Individual TIPS guarantee an inflation-adjusted return if held to maturity, but there is no guarantee for a fund that invests in them. A portfolio manager may buy or sell TIPS before maturity, which could lead to gain or losses.

How can I invest in inflation-protected bonds?

You can purchase TIPS directly from the U.S. Treasury for a minimum purchase amount of \$1,000. You can also buy inflation-indexed savings bonds, or I-bonds. Finally, you can choose a mutual fund or exchange-traded fund that invests in TIPS or other IPBs, which offers the additional benefits of professional management and greater liquidity. Your financial advisor can help you decide whether an investment in inflation-protected bonds or TIPS is right for you.