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Vice President, Fixed-Income

Is the Role of TIPS in our Portfolio Models Misunderstood?



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Recently we have been asked why we continue to maintain TIPS exposure in our portfolios. We do this through our position in the PIMCO Real Return bond fund. The fund primarily holds TIPS (83% of assets) but it also includes modest allocations elsewhere to spice up the returns. Undoubtedly, much of the questioning stems from the disappointing performance that TIPS turned in during 2006. We believe, that in such situations, investors often misinterpret the role of an asset class we hold - not just TIPS, but any under-performing area.

Background

Before I begin on our reasoning though, let me provide a little background. The U.S. Treasury has been issuing Treasury Inflation-Protected Securities (TIPS) since 1997. TIPS provide investors with protection against inflation. The principal value (face value) of TIPS increases as inflation increases and decreases as inflation decreases (disinflation), as measured by the Consumer Price Index.

When TIPS mature, investors are paid the inflation-adjusted principal or the original principal, whichever is greater. Since a TIPS investor won't receive less than the original principal, the investor's original principal amount is protected against both inflation and disinflation. While TIPS pay interest semiannually at a fixed interest rate, that rate is applied to the adjusted principal; so, interest *payments* rise and fall with inflation. More detailed information can be found at www.treasurydirect.gov

High-Quality Bonds

We use bonds to diversify and reduce portfolio volatility and TIPS are, first and foremost, Treasury bonds, so they have essentially zero credit exposure (risk). High-quality bonds such as Treasuries can be seen as a hedge against economic and market weakness (witness the strong performance that bonds turned in on February 27th, the day the Dow dropped 416 points). As we saw then, when uncertainty (increased risk) suddenly occurs in a sector, there is a "flight to quality," as investors rush to get out of the affected area and head for safer ground. As a result, longer-term, high-quality bonds can provide more powerful diversification to equity portfolios than cash.

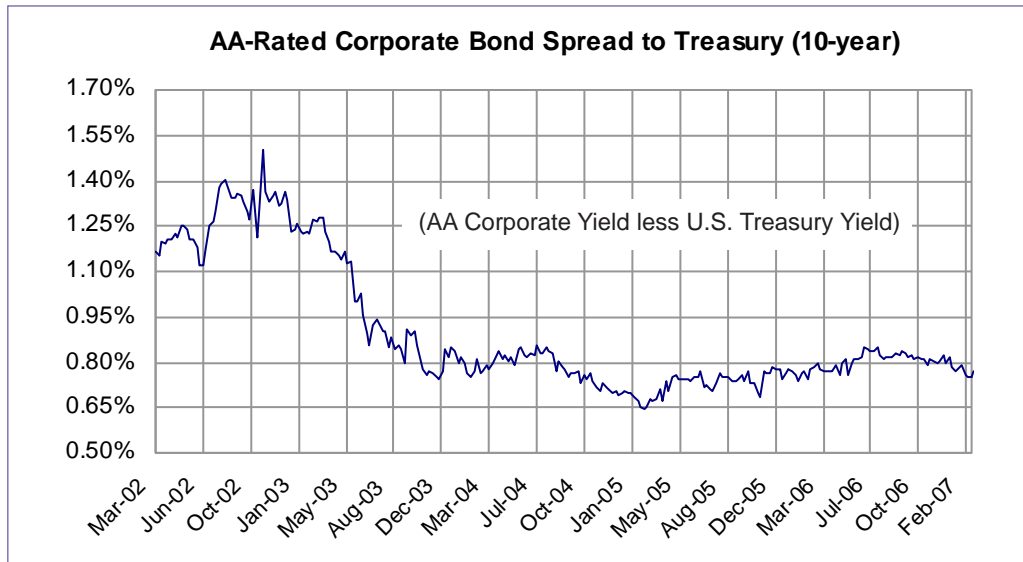
Our primary reason for owning TIPS today is that we have a preference for high-quality bonds in the current market environment. And our primary reason for favoring high-quality is that credit spreads are tight. That is to say that the spreads between the yields available on "risk-free" (from a credit standpoint) Treasury bonds and corporate bonds (with varying degrees of credit risk), are very narrow. In our opinion, the yield premiums that investors receive are so low, that they are not worth the added credit risk assumed. We are not saying that large scale defaults (or anything similar) are on the horizon. Rather, we believe that the probability of credit spreads widening — the yields on lower-quality bonds rising more than the yields on higher-quality bonds and conversely the prices of low-quality debt falling more — is sufficiently high to offset the slim yield advantage offered by lower-quality bonds today.

The chart on the next page demonstrates just how narrow spreads to Treasuries are now versus where

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they were just five years ago. We are using a 10-year AA-rated corporate bond index in the example because we are talking about investment-grade bonds (not high-yield) and the average credit rating in the most widely used fixed-income benchmark, the Lehman Aggregate Bond Index, is close to “AA.”



Inflation Protection

So TIPS provide the high-quality bond exposure we want, but why TIPS instead of conventional Treasuries? As mentioned above, TIPS protect against inflation, and, in our view, an insurance policy against inflation has merit. Many investors might not necessarily think that current inflation levels (2.70% year-over-year on core inflation) are troubling. But, investors with long memories may recall a period in the late 1970s and early 1980s when double-digit inflation was a big issue domestically. We are not suggesting that we are retuning to that level of inflation, but the peace of mind that comes from knowing you have some insulation from the damages of higher inflation on your fixed income portfolio can go a long way.

In a February 28th interview, John Brynjolfsson, manager of PIMCO Real Return, stated that he sees near term inflation being contained in the general area of where it is today. However, longer-term he believes that changing demographics will be one more item pushing inflation higher, and he is concerned about how high it may potentially go.

Inflation Expectations

We may have internal debates on the future of interest rates, but we all agree on the past. From our perspective, we see an economy that has had significant excess liquidity, primarily from a Fed Funds rate that was too low for too long. There are consequences of cheap money in the system, and not all of them are good (anyone seen any articles lately on sub-prime mortgage concerns?). We certainly acknowledge that rates have risen on the short end, but from a historical perspective, rates are still low and low interest rates (cheap money) are kindling for inflation.

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Chairman Bernanke's Fed has made it quite clear that they are in no hurry to lower interest rates as they see a continued threat of inflation. In fact, the Bernanke Fed has gained quite a bit of creditability from the markets from their discipline in staying on message about inflation risks in spite of what have been fairly benign inflation data in recent months.

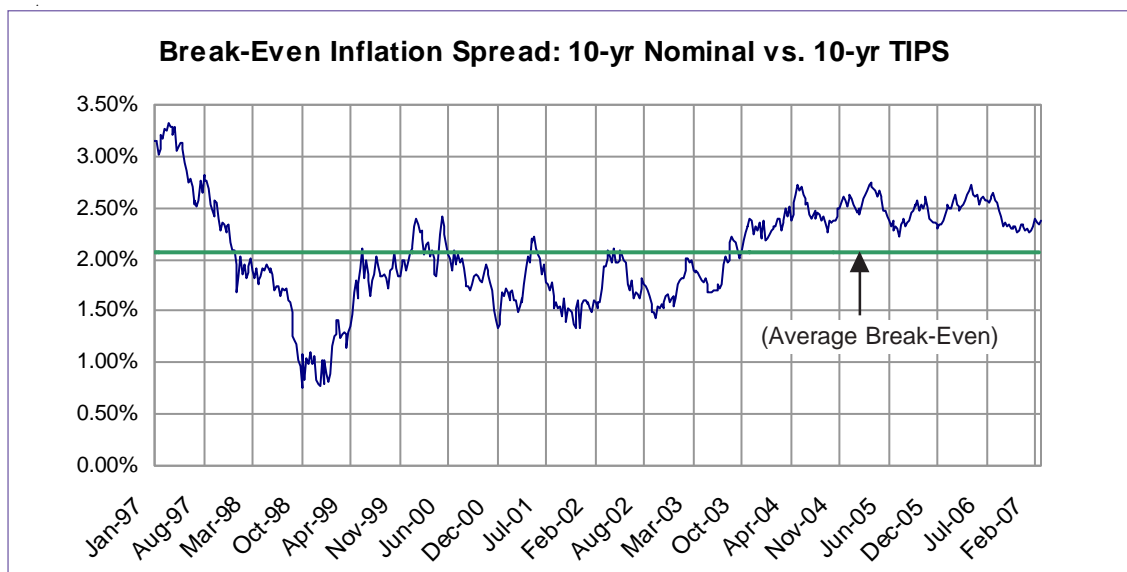
Bernanke's determination to stay-the-course in fighting inflation may serve as a head wind for TIPS, as Bill Irving of Fidelity Inflation Protected Bond recently suggested to me. However, if Bernanke is right about the risks, inflation may indeed creep higher, which would favor TIPS over conventional Treasuries. Inflationary pressures certainly remain throughout the economy (near-full employment, wage growth, higher energy, medical and educational costs). In fact, just last week we saw some less than benign inflation data released by the Labor Department followed by an increase in the Fed's preferred inflation measure, the PCE (personal consumption expenditures) deflator.

Any one item by itself may not be cause for concern. But collectively they say to us that the perception that inflation isn't a threat is just plain wrong. When the most recent data was released, TIPS performed well. In fact, after two full months of the new calendar year, the main TIPS index is the best performer among all domestic fixed-income indices, including non-investment grade indices.

There is legitimate debate within market and economic circles as to whether or not we are about to enter a period of weaker economic activity. This is likely to be influenced by the weakness in the housing market, which has certainly seen its share of volatility. Credit spreads tend to widen-out during periods of economic weakness, thus hurting the value of lower-quality bonds.

Break-Even Spreads

This is how we see the TIPS world. As shown below, break-even spreads have been both richer and cheaper than they are right now, but they represent the low hanging fruit in the fixed-income



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world. You would be hard pressed to find someone who rationally believes that other sectors are cheap. Current break-even spreads (the difference between the yields on the 10-year Treasuries less the yields on 10-year TIPS) are cheap. The current spread of 2.38% means that an investor needs a minimum inflation rate of only 2.38% over the next ten years to make it worth his while to invest in 10-year TIPS over conventional (or nominal) 10-Year Treasury bonds. As I mentioned above, the most recent inflation read is 2.70%.

Summary

Lastly, while we make our own independent asset allocations and decisions, we have some pretty good company in other professional investors who share our thinking. Such value-based asset allocators as Rob Arnott and Jeremy Grantham, have both recently commented that TIPS remain a favorite asset class. Rob recently showed us a United Kingdom inflation-linked bond that was part of a 50-year offering (it matures in 2055) that is trading with a yield of — no this is not a typo — 0.75%! Sort of makes US Treasury inflation-linked long bonds that trade with real yields of around 2.25% seem very attractive. Rob believes that there is plenty of room for appreciation in U.S. TIPS. Finally, David Swensen, who is the Chief Investment Officer at Yale University, suggests that long-term investors have an allocation of 15% in TIPS.

We are not holding TIPS because we think they are going to outperform equities. We are holding them because we want to have a high-quality, low-volatility asset to diversify and reduce risk in your portfolio. If we are aiming for quality in fixed-income, then U.S. Treasury debt is the highest in the world. And if Treasuries are the answer, then why not Treasuries that also include a cheap insurance policy to protect you against inflation?



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