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TIPS ETF Driven Higher By Inflation Worries

By JOANNE VON ALROTH

Call it fear insurance. The current flight to quality has investors eschewing equities for fixed-income strategies.

One of the hottest strategies has been funds that feature Treasury Inflation Protected Securities, or TIPS. On Monday, the **iShares Treasury Lehmann Tips** (TIP) fund hit an all-time high of 111.81, though it dropped 1% Tuesday. The fund, which tracks the performance of the Lehman Brothers Treasury Inflation Notes Index, is up 5.5% year to date.

TIPS have returned 6.2% since Jan. 1, and Treasuries just 3.7%.

The reason for the fund's sizzle? People are afraid of inflation, and they're afraid of losing their principal. With a TIPS investment, investors stave off both bugaboos, said J. Mark Spallanzani, managing partner at Alcott Capital Management and publisher of ETFWatch.com. Spallanzani has been long on TIPS for more than two years.

"You're getting a guarantee from the government and you're getting inflation protection," Spallanzani said. "You've got a negative yield, but you're still going to get some money back."

Mechanics

It works like this: The yield on the five-year TIPS due in 2012 was -.2% Monday. That means the yield is less than the Treasury equivalent. It's been negative since Feb. 29.

Though a TIPS holder essentially pays the government to own the security, TIPS pay interest twice a year at a fixed rate. Investors make money because the principal rises with the consumer price index. Because the rate is applied to the adjusted principal, interest payments rise with inflation. Investors receive either the adjusted principal or original principal, whichever is greater.

Negative Yield

A negative yield says that investors think inflation is going to stay up. If it does, they'll get the inflation-adjusted return of principal.

Much of the recent run was the result of inflation worries and a Wall Street rumor that Bear Stearns had a liquidity problem, analysts say. Both kept the TIPS ETF rising.

The Federal Reserve is pumping more money into the financial system with rate cuts and by taking agency-backed securities. As long as the system is in gridlock, TIPS will likely stay high.

"The Fed has to do a lot of easing to catch up to the market, and these products are going to benefit," Spallanzani said.

Don't expect the fund — or TIPS in general — to soar for very long, though. Spallanzani predicts that mortgage-backed securities will be the next hot ticket, because of their spread over treasuries.

Investors also should keep an eye on financial sector funds, such as **SPDR Financial Select (XLF)** fund. Once such ETFs bottom out, Spallanzani says, holders of TIPS or TIPS funds will see their interest payments dry up.

That's the bad news. It also will signal the end of the credit crisis.



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