RESEARCH

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"TIPS"
(TREASURY INFLATION-PROTECTED SECURITIES): AN ASSET CLASS UNTO ITSELF

Executive Summary

Inflation-indexed bonds under-performed until 2000 but since then have performed competitively with the U.S. Treasury cash bond. Even with this, they still are behind on a five-year cumulative basis. In mid-2002, we amended our view because of changes in the market structure and demand for these securities. We participated in the 10-year, $10-billion TIPS auction in July 2002 and added to portfolios the new 10-year TIPS 3% of 7/15/12 as a new asset class.

Attached is a chart titled "Inflation Gap," which shows the historical spread yield between the latest 10-year Treasury cash bond and the latest 10-year TIPS since their initial issuance in February 1997, along with four reasons for our purchase decision.

Background

The first issuance of TIPS was in February 1997. Now there is more than six years of TIPS history, and the TIPS market is more than $141 billion, or 3.8%, of the total $3.7 trillion outstanding marketable Treasury debt held by the public. The U.S. Treasury department has assured investors they are an integral part of the government's debt management strategy. The current Administration has announced that it intends to keep the TIPS program in place without a review for change for at least another five years, and is increasing the new-issuance frequency from three to four times per year.

How They Work

Currently, 10-year TIPS yield 1.73%. That is 1.69% less than the 3.43% that one will get with a 10-year U.S. Treasury note (the cash bond). Twice a year, the principal will be increased to offset any rise in inflation. If inflation rises, the principal will be increased to offset any rise in inflation and interest going forward will be calculated on a higher base. As long as inflation remains greater than 1.7%, the difference between the regular Treasury's 3.43% yield and the 1.73% TIPS yield. TIPS are a bet. Like all U.S. Government securities, TIPS are guaranteed to return 100% of principal security.

Performance Considerations

The coupon payment and the accretion of principal that occurs each coupon date will be treated as income for tax purposes. Hence these securities are favorable for those accounts that defer or are not subject to income taxes. The coupon payments on TIPS remain the same but they are paid on ever-rising principal value.

Inflation-indexed bonds are a less volatile form of nominal bonds. The real value of their income flow is more stable and their valuation is less volatile. As such, they are best suited to corporate institutions, where stable cash flows are highly valued and yield is relatively less important. Additionally, investment bankers only short the cash bonds to hedge underwriting corporate or agency securities; they never short the TIPS. As a result, TIPS are much less volatile than the cash bond.

New Conditions

A key issue for the demand and appropriateness of TIPS has been the increased use of new benefits, especially to municipal pension funds, which actually are inflation-indexed (i.e., Cost of Living, or "COLA") adjustment benefits, used notably in New York and California. In the case of the New York State Common Fund, they presently have close to 6%, or $5.6 billion, of their $98.7-billion portfolio as of 3/31/03 in TIPS as the natural hedge against their COLA benefits. These inflation-linked obligations make appropriate a similar type of asset. They are, of course, bought and put away as they are long-term obligations.

The protocol of the non-seasonally adjusted U.S. City Average All Items Consumer Price Index for All Urban Consumers (CPI-U) represents prices of all goods and services purchased for consumption by urban households. User fees (such as water and sewer service) as well as sales and excise taxes paid by the consumer also are included. The recent run-up in tobacco tax increases (where cigarettes in New York City now cost $7.00+ per pack) is the most notable recent example of this poor statistical technique. Given our view of the ongoing need for revenue enhancement at all levels of government, this should provide a false floor to the CPI but should not be indicative of inflationary pressure. The tobacco increases do not measure consumption or distribution change (i.e., buying out-of-state or from Native American reservations).

U.S. CPI Urban Consumers
Year-Over-Year, Non-Seasonally Adjusted
3/31/000 — 4/30/03
HI 3.8; AVE 2.3; LOW 1.1

Date	Value (%)	Date	Value (%)	Date	Value (%)
4/03	2.2	*4/02*	1.6	*4/01*	3.3
3/03	3.0	*3/02*	1.5	*3/01*	2.9
2/03	3.0	*2/02*	1.1	*2/01*	3.5
1/03	2.6	*1/02*	1.1	*1/01*	3.7
12/02	2.4	*12/01*	1.6	*12/00*	3.4
11/02	2.2	*11/01*	1.9	*11/00*	3.4
10/02	2.0	*10/01*	2.1	*10/00*	3.4
9/02	1.5	*9/01*	2.6	*9/00*	3.5
8/02	1.8	*8/01*	2.7	*8/00*	3.4
7/02	1.5	*7/01*	2.7	*7/00*	3.7
6/02	**L 1.1**	*6/01*	3.2	***3/00***	**H 3.8**
5/02	1.2	*5/01*	3.6		

The equity bear market is fostering reduced allocation to equities because of a previous outlook for corporate profits but not because of the reduced ability to act as an inflation edge. As the role of equities diminishes, the need for an additional secure asset class to provide an inflation hedge will increase.

Low levels of nominal interest rates, with 90-Day U.S. Treasury bills at 1.02% and spreads in the lower half of their range to the cash bond, afford cheap longer-term inflation protection in a high quality sector (U.S. Treasuries) with an ability to add maturity or duration to the portfolio, particularly when that is our near-term goal.

In conclusion, we have elected to own TIPS because of our assessment of a changed environment, not for what has been the traditionally accepted insurance rationale. Our purchase was for active-management reasons and should not be construed as passive in any way.

Smith Affiliated Capital Corp. (SAC) is a registered investment advisory firm based in New York. The firm was founded in 1982 to design and implement fixed-income strategies for institutional and individual clients. It specializes in the active management of high quality taxable and tax-exempt portfolios for either total-return or liability-specific needs.

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