Recent high inflation in the U.S. has led to investor interest in hedges against further increases in the Consumer Price Index (CPI). Given our view that the Fed will ultimately be successful in bringing inflation under control while likely maintaining positive U.S. economic growth, our preferred positioning does not include a direct inflation hedge, instead relying on equities, subordinated debt, and floating rate loans. We feel this profile offers an attractive blend of income and potential asset price appreciation.

Investors who prefer a direct inflation hedge from a government security have two alternatives: Treasury Inflation-Protected Securities (TIPS) or Series I Savings Bonds (I-bonds). Despite both providing an inflation hedge, there are meaningful differences between the two instruments and each has significant drawbacks, in our opinion. We believe investors should maintain minimal, if any, exposure to TIPS at current price levels. Depending on client circumstances, we see some potential use cases for I-bonds as a repository for earmarked funds.

Comparing TIPS and I-bonds

The table on the next page summarizes the differences between the two investments, but the key distinction is that TIPS function like other government or corporate bonds, while I-bonds act more like a direct loan to the U.S. government.

TIPS are government bonds that are traded like Treasury or corporate bonds. There are no restrictions on purchase amount, and the yield and coupon will vary with trading conditions at the time of purchase. TIPS can also be sold for cash at any point.

I-bonds, on the other hand, are closer to a direct loan to the U.S. government; they can only be purchased online through TreasuryDirect, the federal government’s direct-to-investor issuance platform, or via a paper tax return refund. After issuance, I-bonds cannot be transferred to another account or sold to another investor. This means that consolidation with other portfolio holdings must be done manually and the securities themselves cannot be transferred into a standard brokerage or investment account. Electronic purchases are also limited to $10,000 per year per U.S. investor, although an additional $5,000 in paper bonds can be bought with a tax refund. As importantly, the bonds cannot be redeemed for at least one year after purchase, and any redemption before year six requires forfeiting three months of interest. I-bonds, in short, are designed to be longer-term in nature.

Inflation hedge

TIPS and I-bonds both compensate investors for inflation but they do so in different ways.

TIPS provide semi-annual coupon payments that change based on the level of inflation. This is accomplished by paying a fixed coupon rate throughout the life of the security, but adjusting the bond’s principal amount by accumulated inflation. So a 1% TIPS bond will always pay a coupon of 1% per annum, but the 1% will be calculated based on a par amount that varies with historical inflation levels. If, for instance, accumulated inflation has been 10% since the issuance of a 1% TIPS, the coupon would be calculated as 1% of $110, or $1.10, and not 1% of the $100 original par amount. If accumulated inflation is negative at any point during the life of the bond, TIPS coupons may be paid on a value below 100% of par value, but at maturity TIPS will always return at least par value to the investor. Further details on the TIPS calculation can be found here.

One point for investors to keep in mind is that the adjustments to par value are considered taxable events, so that high inflation periods could create negative cash flow, depending on tax circumstances. This would be likely for large notional adjustments on low coupon bonds, such as we are currently experiencing.

I-bonds do not pay cash coupons. Instead, they make semi-annual adjustments to the principal amount based on inflation.
on the most recent CPI inflation report plus a fixed percentage spread (the current fixed spread is 0%). This interest is then compounded and the next coupon value will be calculated based on the higher principal amount. One benefit to the I-bond calculation is that if inflation were to dip negative, the compounded interest payment is floored at zero. This provides investors with potential benefits if we were to see a negative inflation environment. TreasuryDirect provides further details on the I-bond on its website.

I-bond interest compounding is not a taxable event; investors instead pay ordinary income rates at redemption.

**Adding TIPS or I-bonds**

We do not favor TIPS at current levels. We believe the Fed will be successful in eventually controlling inflation and that investors are paying too high a price for the insurance provided.

I-bonds are more attractive on a dollar-for-dollar basis, in our opinion, but the limitations on their purchase and incorporation into other accounts is a serious drawback. Our view is that they may be useful for certain investors in certain cases; families with college-bound children, for instance, may be able to use them to create a high-quality cash flow to match future tuition liabilities. The ability to gift I-bonds means that the practical limit for a household is $10,000 per year per household member with a Social Security number, allowing some accumulation of assets in the security. Again, however, we believe that future inflation is unlikely to persist at these levels, meaning that investors may want to take advantage of these in a limited fashion now, but are unlikely to find them a key component of future portfolio construction.

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**Comparison of TIPS and I-bonds**

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Source - RBC Wealth Management
Inflated expectations: I-bonds and TIPS may be less helpful than hoped, continued

Inflated expectations: I-bonds and TIPS may be less helpful than hoped, continued

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