



Actively Managed TIPS – A Correction

By Robert Huebscher

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Our August 18 article, [Actively Managed TIPS?](#), contained a glaring factual error that I need to correct. In addition, a reader has challenged some of my assertions, and I want to respond to those challenges.

The error was my statement that the Vanguard fund VIPSX is the only actively managed TIPS fund. PIMCO also has a large actively managed TIPS fund, PRRIX, as do as many as 25 other fund companies. Vanguard's and PIMCO's funds are by far the largest.

The performance of PRRIX is notably better than that of VIPSX, as Bob Marshalla of Marshalla Asset Management in Los Altos, CA, points out:

Robert Huebscher's article in today's Advisor's Perspectives rips PIMCO's contention that active management of TIPS makes sense. It seemed strange to see that he compared the performance of a Vanguard active fund to that of the passive TIP ETF, but did not show the returns for the PIMCO fund itself. So I looked it up on Morningstar.com. Now I see why he left it out. It turns out the PIMCO Real Return (PRRIX) has outperformed TIP for each of the past one, three and five year periods. For one year, the score is +0.65% for PIMCO, to -1.16% for TIP. For three years it is 5.15% to 4.83%, and for five years, 4.60% to 4.20%. These returns are after fees. And, by the way, the OER for PRRIX, which is the fund I use for my clients, is 0.45%, a far cry from the 75 to 100 basis points that Huebscher quotes. Huebscher's article is dishonest. It appears he had a point to make and he made it without letting any inconvenient facts get in the way. I am mystified as to why he would try to dissuade people from using this fund/approach.

To understand the source of this outperformance, I reviewed the fund's prospectus and fact sheet and spoke with John Cavalieri, the primary author of the study cited in my article and the Real Return Product Manager at PIMCO.

Cavalieri explained that PRRIX, by its prospectus, holds at least 80% in inflation-linked bonds at all times, which are primarily US TIPS. PRRIX can also hold limited amounts of inflation-linked bonds of other developed countries, as well some non-inflation-linked bond and derivatives including options, forward contracts, or other derivatives tied to TIPS. These positions are used to express short-term relative value views versus TIPS.



When PRRIX uses certain derivatives, it must also post cash and cash-equivalent collateral so as not to create leverage. Morningstar, when it displays [portfolio holdings](#), incorrectly includes this collateral as part of the fund's holdings. This was the reason for my misclassification of PRRIX; Morningstar's data incorrectly indicates the fund currently has only 35% of its assets in TIPS.

PIMCO manages the PRRIX fund in the same manner as its other actively managed bond funds, which Cavalieri explained in an email:

Conceptually, you can think of it as a two-step process (though in practice these steps happen simultaneously). First, we seek to gain more cost efficient exposure to the TIPS market by gaining TIPS positions that match the risk exposures of the TIPS index, but we do so in a way that navigates around the structural inefficiencies in the TIPS market that were the topic of our paper. Second, we incorporate our active views as modest relative value deviations from the index-specified positions. These views come in two groups – macro "top-down" views and more micro "bottom-up" views. Top down strategies include duration, curve positioning, break-even inflation widening/narrowing, country rotation among developed inflation-linked bond (ILB) issuers and sector rotation. Bottom up strategies include seasonality trades, on the run/off the run premiums, general issue selection and relative value based on implied optionality in the embedded deflation put within TIPS (at maturity, TIPS return not less than original principal value, which means TIPS buyers can put inflation risk back to the government at that time).

PRRIX's managers will use whatever financial instrument (TIPS, other bonds or derivatives, subject to prospectus limits) allow them to most effectively express their active views and exploit market inefficiencies. Cavalieri said that its limited use of derivatives is done in a "risk-neutral" fashion relative to using the actual bonds and is not analogous to, for example, using leverage in the fund.

PRRIX has a 97% correlation to the TIP index over its lifetime, and its impressive performance history speaks to the skill of its active managers.

I am not persuaded, however, that the performance of PRRIX serves as evidence that the TIPS market is inefficient or that active management can succeed in the future. PRRIX is permitted to hold up to 20% in non-TIPS assets, which can include corporate, Treasury and agency bonds. Currently, it is underweight TIPS and holds 18% of the fund in non-TIPS. PRRIX's outperformance may have come from shrewd bets outside the TIPS market. It may have also come from its use of TIPS derivatives. I will leave it to the reader to answer the semantic question of whether these derivatives should be considered part of the TIPS market.



TIPS have gained increased attention in the last year, as investors fear both inflation and deflation. The assets of TIPS funds have grown, making the market more competitive for active managers. As I stated in my original article, both the homogeneity of the basic TIPS product and the ability of funds to accurately detect and analyze inefficiencies in the TIPS market with automated quantitative models should quickly erase inefficiencies and reduce returns to active funds, even for the skillful managers at PIMCO.

Cavalieri asked me to point out one other statement in my article that could be misleading. I said that 10-year TIPS currently yield just under 2%, so investors in PRRIX (which has an expense ratio of .45) sacrifice approximately one-quarter of the yield in management fees. That is the stated "real" yield on TIPS and assumes no inflation. What I failed to note was that TIPS total effective yield is the combination of the stated real yield plus actual future CPI. So if you think average inflation over the next 10 years will be 3%, then TIPS are really yielding 5%. This linkage to actual CPI is why TIPS returns increase in an inflationary environment. They may also decrease in a deflationary environment.

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