



TIPS – When a Discount is Really a Premium

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Our article last week, [Opportunities and Risks in TIPS](#), elicited questions from several readers regarding whether TIPS priced at a discount to par are more valuable than those priced at a premium. The question arises for TIPS because they are protected at par at maturity – the Treasury guarantees that the final principal payment will be at least 100, offering an advantage in a deflationary environment.

For nominal Treasury bonds this question is moot. It is relevant for TIPS in a deflationary environment but not an inflationary one.

It turns out that discount bonds are more valuable, but the market may already be pricing them appropriately.

Consider the following two 19-year TIPS, using pricing data obtained from Bloomberg at the close of business on May 22:

Coupon	Maturity	Bid Price (32nds)	Yield	Accrued Principal
1.750	1/15/28	90.30	2.352	101.4
3.625	4/15/28	117.27	2.439	131.4

These bonds differ in maturity by only three months and their yields differ by nine basis points. The first is priced at a discount and the second is a seasoned issue, with substantial accrued principal, priced at a premium.

The bonds' performance differs markedly under different deflationary assumptions, but is consistent if inflation ensues:

Assumed Annual CPI Change (%)	Discount Bond IRR (%)	Premium Bond IRR (%)	Performance Advantage of Discount Bond (Basis Points)
-3	1.94	1.72	22
-2	2.06	1.93	13
-1	2.20	2.18	2
0	2.35	2.44	-9
1	3.37	3.46	-9



2	4.39	4.49	-10
3	5.42	5.51	-9

If deflation persists at -3% annually over the 19-year life of these bonds, the discount bond gains an additional 31 basis points in performance (22 versus -9 basis points) relative to the premium bond. The principal value of both bonds will fall substantially below 100 prior to maturity, and both bonds will benefit from their protection at par. The discount bond is more valuable because the relative cheapness of the bond today (i.e., its discount price) more than offsets the greater cash flows over time from the premium bond.

Under inflationary scenarios, their performance difference approximates the 9 basis point difference in the bonds' current yields to maturity.

These results assume the bonds are held to maturity. Bonds sold prior to maturity are subject to market risk, primarily due to volatility in real interest rates.

The relative value of discount bonds persists regardless of the maturity of the bond. In the above example, if the maturities of the two bonds are changed from 19 to 10 years, the discount bond gains an additional 18 basis points in performance relative to the premium bond, based on -3% annual deflation.

Our Treasury Department seems to have figured this out. Recently, instead of auctioning newly created bonds priced at par, it has re-opened seasoned issues and auctioned them at a premium.

The market may have figured this out too. In the above example, the premium bond is priced to yield an additional 9 basis. Investors need to assess whether this is sufficient to compensate for the additional risk in deflationary scenarios.

TIPS indices are constructed to replicate the broad market, regardless of whether bonds are auctioned or priced at a discount or premium. An advantage to owning individual bonds, relative to an ETF, is that investors can purchase exclusively discount bonds.

In the TIPS market, bonds priced at a discount have a value premium.

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