

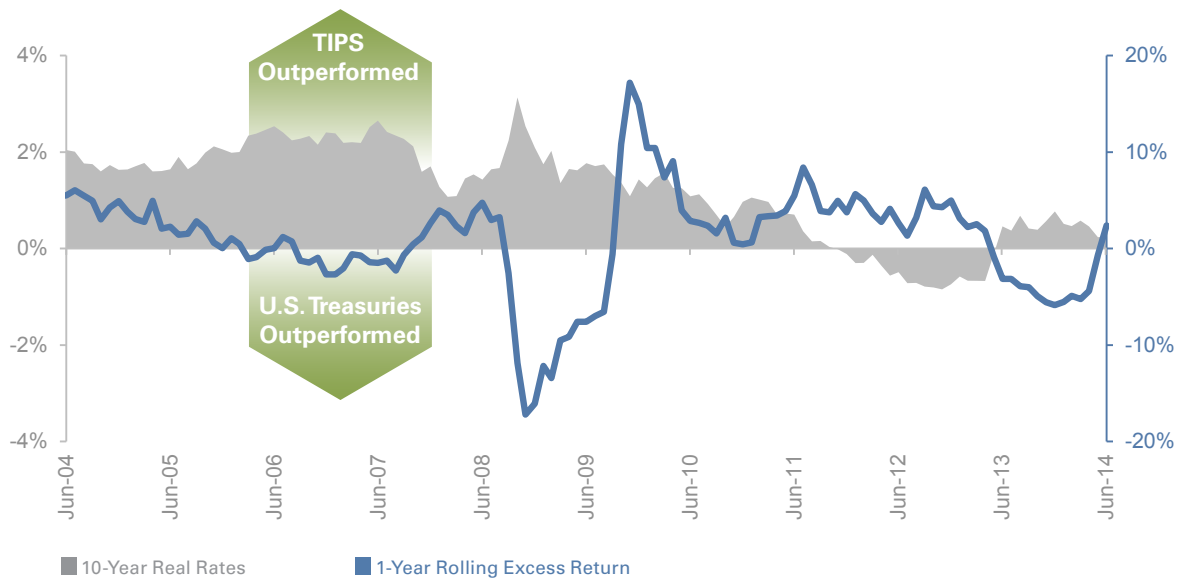
# TIPS: Opportunities for Active Management

by John Hendricks, *Executive Vice President and Senior Portfolio Manager*

When seeking to hedge against rising inflation, there are a number of investment options in the marketplace. Treasury Inflation-Protected Securities (TIPS) are the most direct inflation hedge, as TIPS' principal is linked to the CPI-U (Consumer Price Index for All Urban Consumers). Other traditional inflation hedges typically display varying degrees of sensitivity to inflation depending on the time horizon.

Once a decision is made to allocate to the TIPS asset class, the next question for investors is whether to adopt a passive or an active strategy. TIPS, after all, are essentially a U.S. Treasury security (i.e. an efficient asset class) and there are only 35 securities in the Barclays U.S. TIPS Index. The tendency is to conclude that there is limited opportunity for an asset manager to outperform the benchmark. We would not agree with that conclusion.

**Figure 1. Excess Return of TIPS over Nominal U.S. Treasuries in Various Real Rate Environments**



Excess Return = Barclays U.S. TIPS Index 1-Year Rolling Return minus Barclays U.S. Treasury Index 1-Year Rolling Return. 10-Year Real Rates is represented by 10-Year Generic Inflation Indexed U.S. Treasury bonds.

Source: Bloomberg, Barclays Live as of 6/30/2014. Past performance is no guarantee of future results.

In our opinion, an active management style may lead to long-term outperformance versus a passive approach. We would go even further and assert that an active manager may outperform while pursuing a “pure” style, which we equate to maintaining on average a high allocation (≥90%) to inflation-linked bonds over time.

Some inflation hedging strategies incorporate other asset classes to attempt to enhance portfolio yield and return. Our approach has been to preserve the potential diversification benefits of the asset class while at the same time capitalizing on the unique characteristics of TIPS. The TIPS asset class is not so efficient that a manager can't outperform versus the benchmark or remain competitive versus a varied peer group.

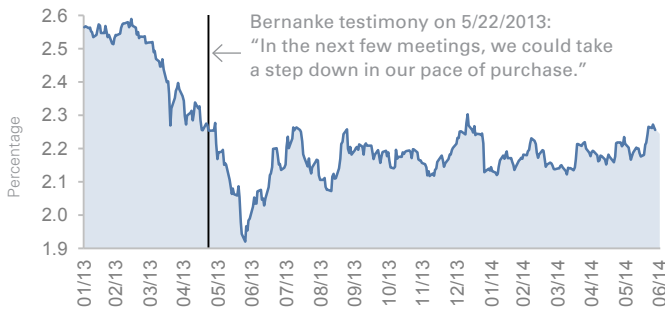
Active managers, of course, have the ability to incorporate macro views and relative value strategies into their investment process. The following highlights a number of approaches that may allow active managers to outperform versus the benchmark and seek to protect clients when market conditions turn unfavorable for the TIPS asset class.

**Figure 2. U.S. TIPS 10-yr Breakeven Rates, 2009-2014**



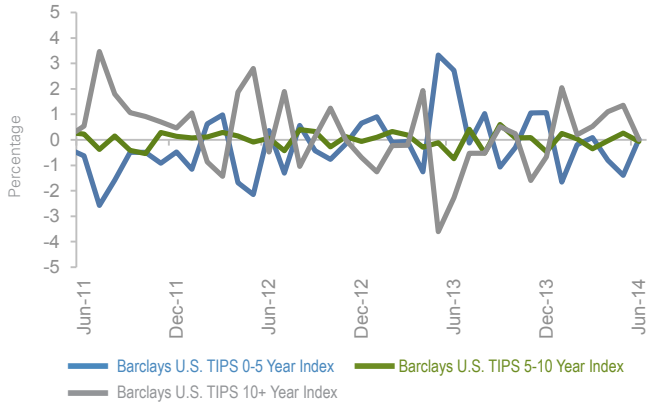
Source: Bloomberg, as of June 30, 2014

**Figure 3. U.S. TIPS 10-yr Breakeven Rates, 2013-2014**



Source: Bloomberg, as of June 30, 2014

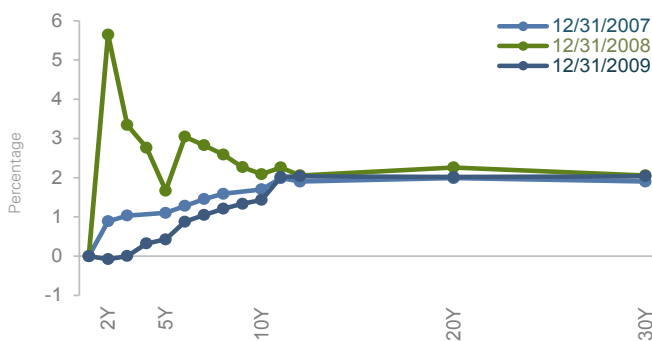
**Figure 4. TIPS Excess Return Vs Index by Maturity**



Excess is comparison to Barclays U.S. TIPS Index.

Source: Barclays Live, as of June 30, 2014. Past performance is no guarantee of future results.

**Figure 5. Real Yield Curves 2007-2009**



Source: www.treasurydirect.gov

## Rotation Between TIPS and Nominal Treasuries May Enhance Return

*Active managers can potentially capitalize on the fluctuation in TIPS breakevens.*

- » TIPS fall in and out of favor in the marketplace and this is most readily apparent in breakevens. Tactically allocating away from TIPS when inflation expectations are falling (or likely to fall) may enhance performance (see Figure 2).
- » A recent example of this would be when Federal Reserve (Fed) policymakers started in May 2013 to communicate their intent to exit Quantitative Easing (QE). The more hawkish Fed communication and a benign inflation backdrop caused breakevens to trend lower (see Figure 3).
- » The most striking example of TIPS underperformance was during the financial crisis, when the economy experienced negative growth and deflation (see Figure 1).
- » As a rule, TIPS have performed best in a stagflationary environment (i.e. low to declining growth and rising inflation).

## Positioning On the Real Yield Curve May Have a Dramatic Impact

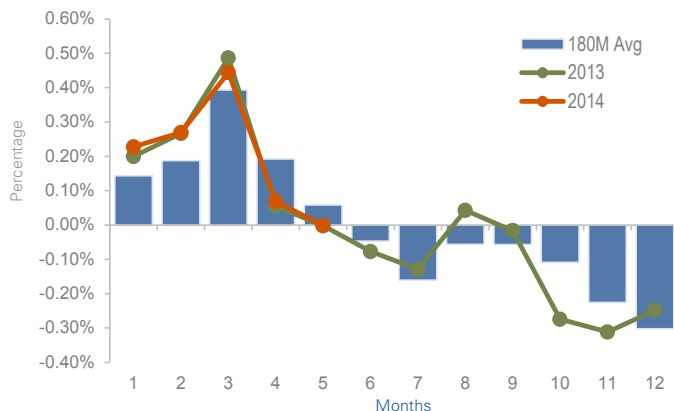
- » Near-term realized inflation and inflation expectations heavily influence shorter-maturity TIPS. Longer-maturity TIPS are influenced more by nominal yields.
- » The volatility of returns in various maturity buckets may present active managers with opportunities to outperform (see Figure 4).
- » Once again, the 2008 financial crisis provides a dramatic example of curve opportunities. In 2008, the real yield curve inverted and then normalized the following year (see Figure 5).
- » Since the inception of the TIPS asset class in 1997, the Barclays U.S. TIPS Index has had only two negative return years (2008 & 2013). In 2008, the TIPS curve inverted and the Barclays U.S. 1-5 Year TIPS Index suffered a negative total return of -5.71% while the Barclays U.S. 10+ Year TIPS Index had a positive return of 1.12%. The full index had a negative annual return of -2.35%.

## Inflation Compensation is Important – but Don't Overlook Price Return

- » TIPS expose investors to interest rate risk and investors will likely suffer lower returns if rates rise with inflation.
- » Active managers can manage interest rate risk by astutely positioning along the real yield curve or by simply underweighting duration risk versus the benchmark.
- » Overlaying derivative strategies may also help insulate a TIPS portfolio in adverse environments.

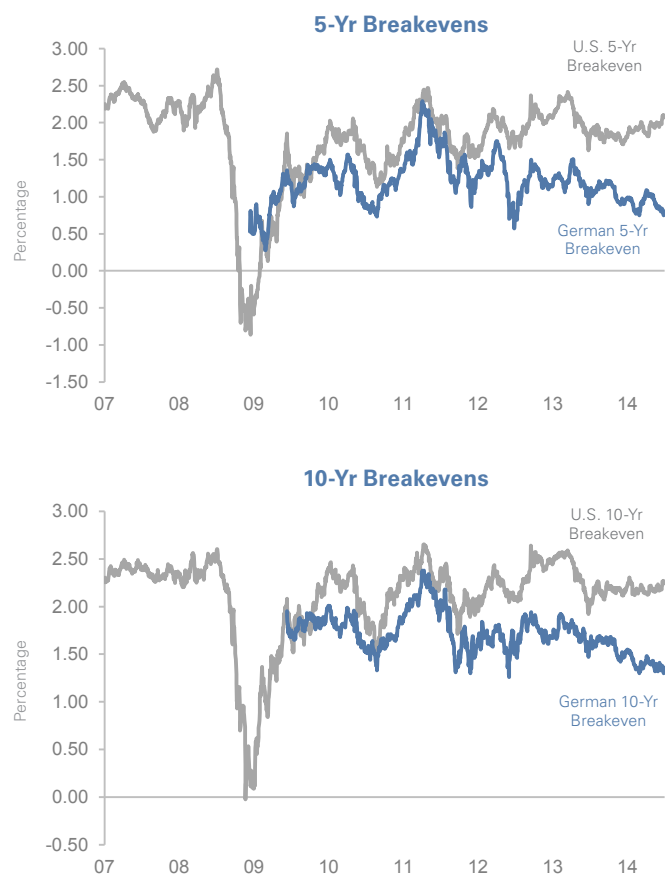
**Figure 6. Difference in Inflation Indicators**

Monthly % difference between non-seasonally adjusted (NSA) and seasonally adjusted CPI.



Source: Bloomberg, as of May 31, 2014

**Figure 7. Differences in U.S./German 5-Yr , 10-Yr Breakevens**



Source: Bloomberg, as of June 30, 2014

## TIPS Valuations Periodically Diverge from the Fundamentals

- » TIPS liquidity is not comparable to liquidity in the nominal market, and this difference may create opportunity.
- » As an example, during “flight-to-quality” episodes TIPS have typically lagged the broader nominal market.
- » Auction dynamics tend to be more pronounced with TIPS. New issuance may distort pricing along the curve and in so doing create opportunity.
- » Seasonal inflation accrual impacts TIPS demand and issue-specific pricing. TIPS of varying maturity months exhibit seasonal patterns due to the fact that TIPS are tied to the non-seasonally-adjusted (NSA) inflation index rather than the seasonally-adjusted version. NSA monthly inflation, in turn, has exhibited a fairly predictable pattern, whereby inflation typically has been highest in the first half of the year and lowest in the latter half (see Figure 6).
- » TIPS flows may be strong around the seasonal inflation pattern as investors seek to capture the high inflation accrual or “positive carry.”

## Opportunity Resides in Global Inflation-linked Bonds

- » Periodically macro divergences between developed economies steps up.
- » This may create significant cross market opportunity for managers that can allocate to non-dollar linkers (see Figure 7).
- » We appear to be entering one of those periods of divergence with U.S. and U.K. monetary policy about to tighten and euro area policy easing.

## Conclusion

The above market data demonstrates that there may be sufficient opportunity in the TIPS market for active managers to outperform. Given past market behavior and the trading dynamics we highlighted, an active TIPS strategy may benefit the performance of a portfolio versus a TIPS index and a passively managed approach.

Going forward, fixed-income investors will likely face greater uncertainty around inflation and interest rates. As the U.S. Federal Reserve seeks to normalize policy after years of unconventional measures, U.S. interest rate volatility will likely pick up. Active management during this transition period could mitigate a number of portfolio risks.

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### About the Author

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Hartford Investment Management has \$1.5 billion in TIPS assets under management as of March 31, 2014, and uses an active management style in an effort to outperform the Barclays U.S. TIPS Index over a market cycle.

### Disclosure

The forecasts, opinions and estimates expressed in this report constitute the Firm's judgment as of June 30, 2014 and are subject to change without notice based on market, economic and other conditions. All investments are subject to risk, including possible loss of principal. TIPS are subject to the risks associated with inflation-protected securities ("IPS"). Risks associated with IPS investments include liquidity risk, interest rate risk, prepayment risk, extension risk and deflation risk (with deflation, the principal value of IPS holdings would be adjusted downward). Diversification cannot assure against market loss.

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