Inflation-Linked Bonds Redux

[Introduction of Inflation-Linked Bonds]

Source: 1996 3Q *TIFF Funds*

Whip Inflation Now

The U.S. Treasury is about to give investors a chance to bet directly on whether this nation can indeed do what an earlier running mate of presidential challenger Bob Dole tried but failed to do during his presidency two decades ago: WIN. (The president was Gerald Ford; the acronym stood for "Whip Inflation Now.") As has been widely reported, in January 1997 the Treasury will begin issuing "Canadian-style" inflation-linked (I/L) bonds. Having burdened our readers with a lengthy dialogue on I/L bonds three months ago, we will not rehash the pros and cons here. The only new things we have learned about this investment opportunity over the last three months are that: (1) the first tranche of I/L bonds will have a 10-year maturity; and (2) the politicians responsible for their introduction are marketing I/L Treasuries in a manner that would land them in jail if they were, say, stock promoters. [1] Such hype may cause individual investors to pay too much for the first tranche of I/L bonds to be marketed early next year, thus depriving institutional investors of what might otherwise have been an interesting profit-making opportunity.

Leverage Anyone?

The opportunity relates to the fact that, as we noted last quarter, Canadian-style I/L bonds are schizoid in the behavioral sense: their duration per unit of maturity is longer than that of a conventional bond (because the inflation "kicker" comes overwhelmingly at maturity), but their price sensitivity is muted due to the very feature just mentioned. More specifically, due to their built-in inflation protection, I/L bonds fluctuate in response to changes in **real** as distinct from **nominal** interest rates, and the former are about 30-50% less volatile than the latter. What this means in practice is that institutions with the requisite trading and legal acumen can theoretically earn attractive risk-adjusted returns by dumping their conventional Treasuries (or even selling them short) and buying I/L Treasuries on a leveraged basis. (Simulations by I/L bond experts Bridgewater Associates suggest that 2:1 gearing makes the risk/return attributes of a leveraged I/L portfolio very competitive with stocks, to say nothing of plain vanilla bonds.) But — and it is a big but — this "trade" could prove unprofitable if individual investors bid up I/L bonds' initial offering prices to sufficiently lofty levels, and it could prove disastrous if real rates skyrocket, as they would during an extended deflation.

Just What America Needs

The TIFF Investment Program stands ready to help its Members exploit any compelling opportunities that arise as the Treasury's new bonds come to market. Indeed, we have given some thought to launching a new fund that would invest primarily in I/L bonds. (The cooperative's existing Bond Fund may also invest opportunistically in I/L issues, subject to duration guidelines specified in the Prospectus.) But our sense is that America's biggest mutual fund families will prove at least as opportunistic in responding to the issuance of I/L Treasuries as the Clinton Administration has been in introducing them, and Americans will soon have what they assumedly want but arguably do not need: even more bond mutual funds to choose among.

Endnote

1. We speak from personal experience, having been lobbied recently by a Treasury official whose job is to drum up interest among investors in the government's new I/L bonds.