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# TIPS Versus Treasuries

Presented at IPPFA Annual Training Conference by:

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**SKBA Capital Management, LLC**

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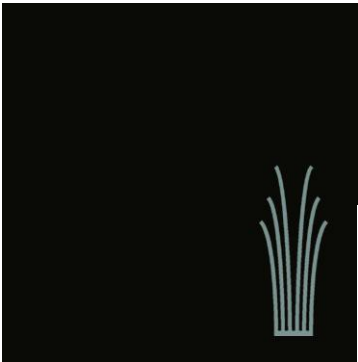
# TIPS Versus Treasuries – Advantages of Each

## Benefits of TIPS

- ✓ Protects against unexpected price inflation in the Urban CPI.
- ✓ Higher potential returns to TIPS as investors systemically underestimate actual versus expected price inflation.
- ✓ Better matches asset returns with the growth in pension liabilities due to cost inflation in wages and benefits.
- ✓ Real yields are normally less volatile than nominal Treasury yields.

## Advantage of Nominal Treasury Bonds

- ✓ Interest payments and principal payment at maturity are fixed and known.
- ✓ In periods of financial distress, nominal T-bonds better diversify stock market risk than TIPS.
- ✓ Treasuries are more liquid investments than TIPS.
- ✓ In sustained deflation, total return to Treasuries outperform TIPS.



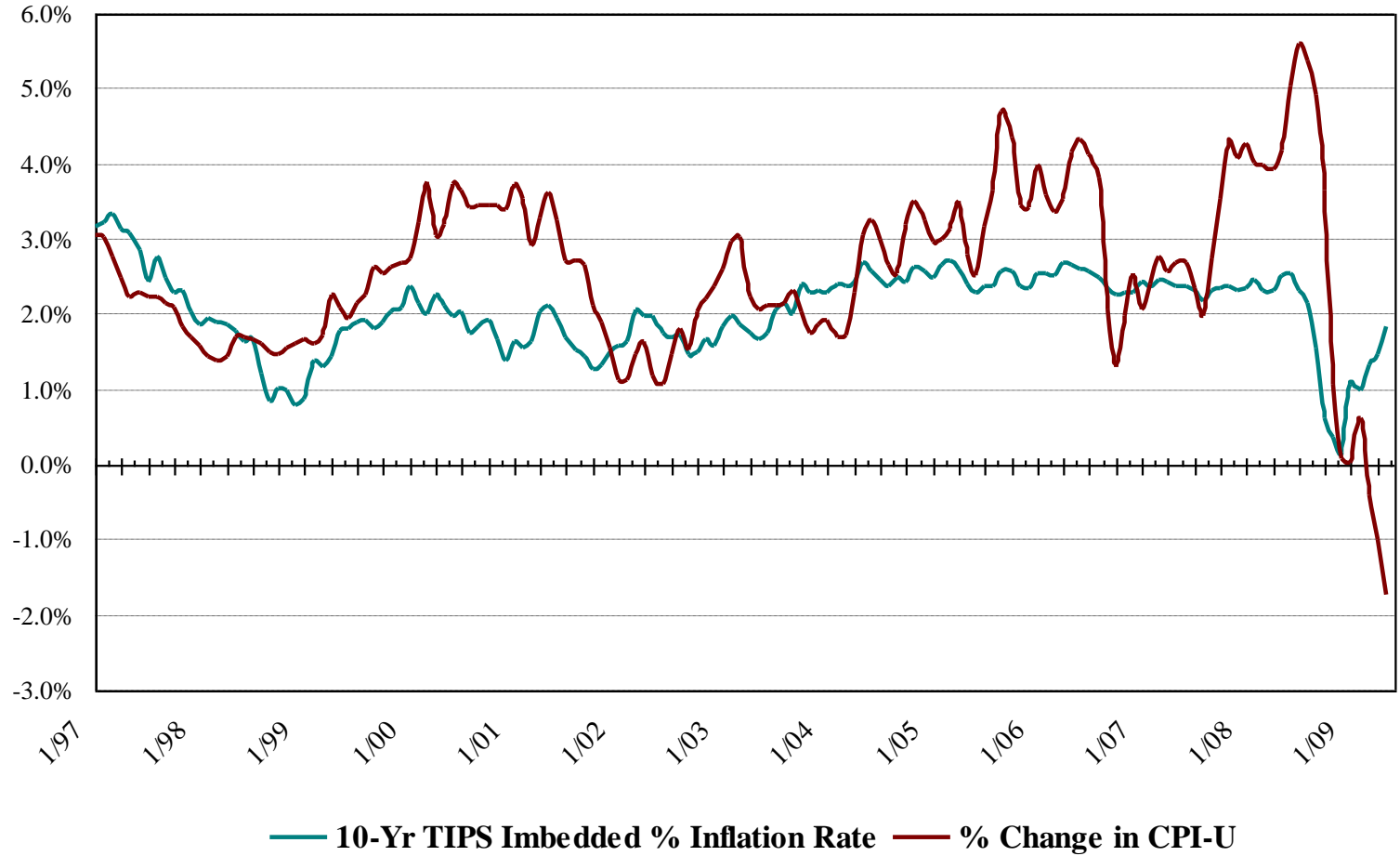
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# CPI vs. Implied Inflation

As of 6/30/09

## Annual CPI-U % Change vs Imbedded Inflation Expectations

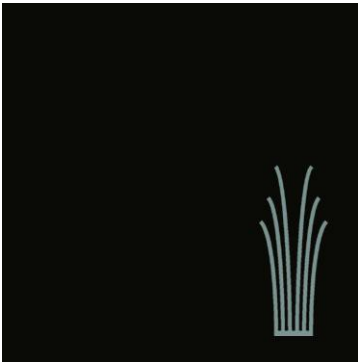


## % Change or Total Returns for Indexes

	<b>CPI-U</b>	<b>Barclays TIPS</b>	<b>Barclays Inter- mediate Treasury</b>	<b>Barclays Long- Term Treasury</b>
<b>June to Dec 2008</b>	<b>-2.5%</b>	<b>-6.9%</b>	<b>8.8%</b>	<b>22.1%</b>
<b>Dec 08 to Aug 2009</b>	<b>1.8%</b>	<b>6.2%</b>	<b>-2.4%</b>	<b>-12.0%</b>

• *Forecasts are subject to change and should not be viewed as a promise of future performance*

• *Source: PSN*



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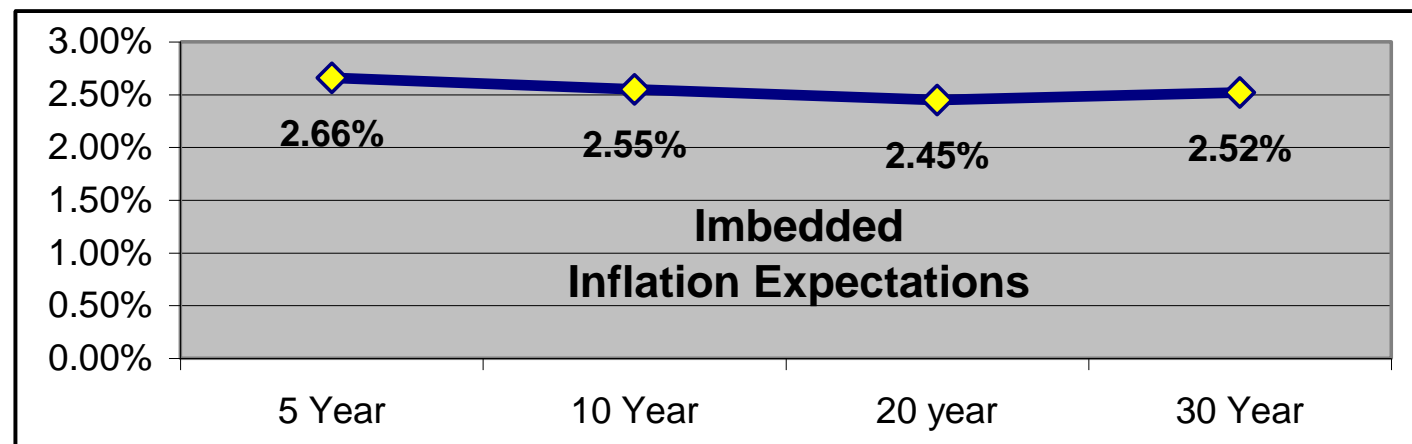
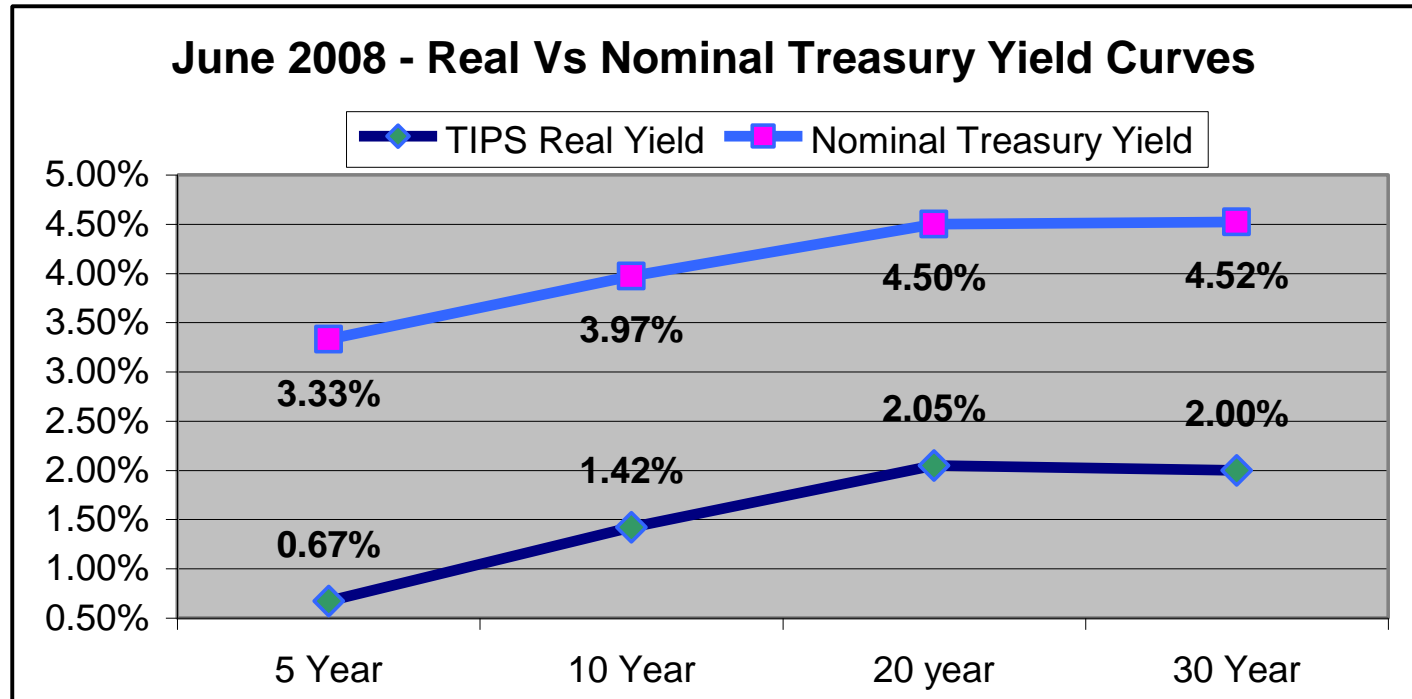
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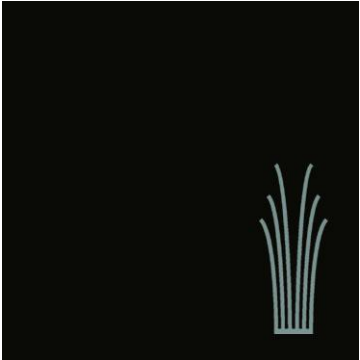
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## June 2008 – Real vs. Nominal Treasury Yields



- *Forecasts are subject to change and should not be viewed as a promise of future performance*
- *Source: Bloomberg*



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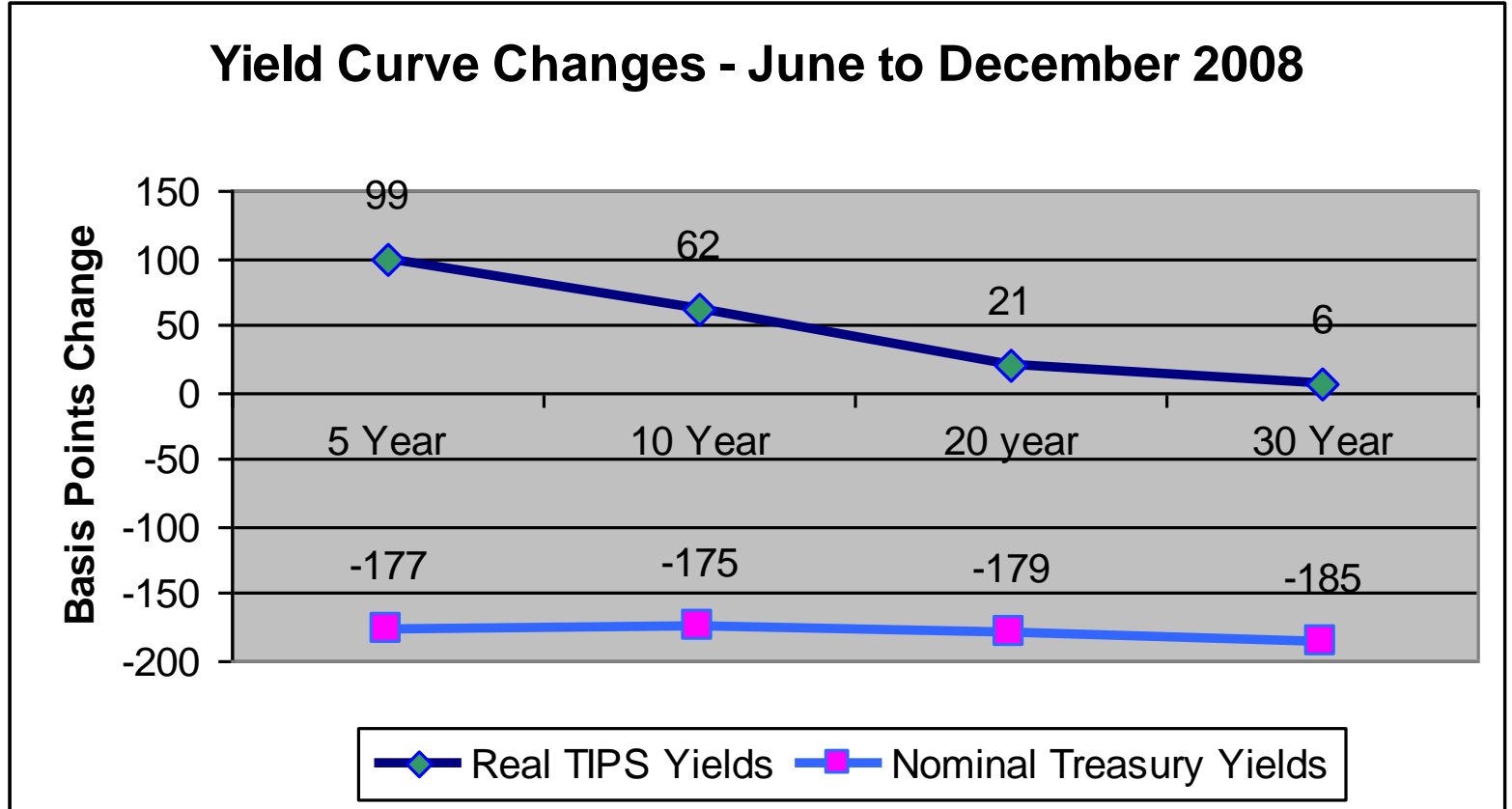
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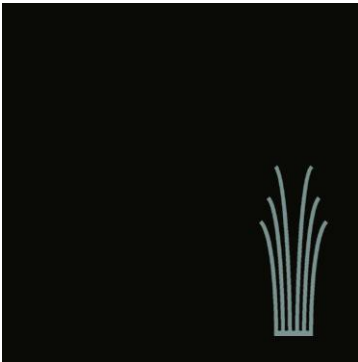
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## Yield Curve Shifts (Basis Points)



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- *Source: Bloomberg*



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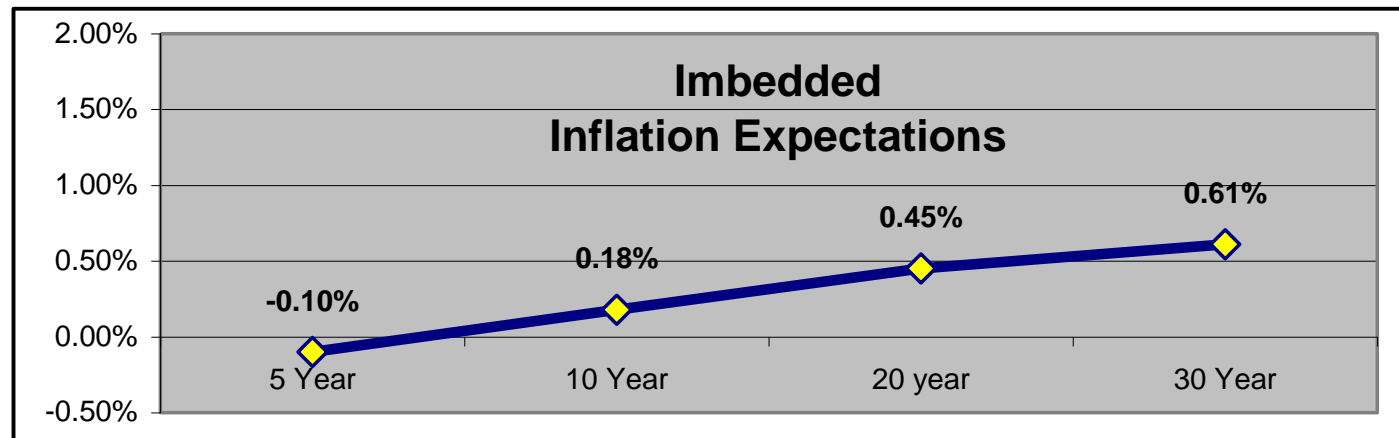
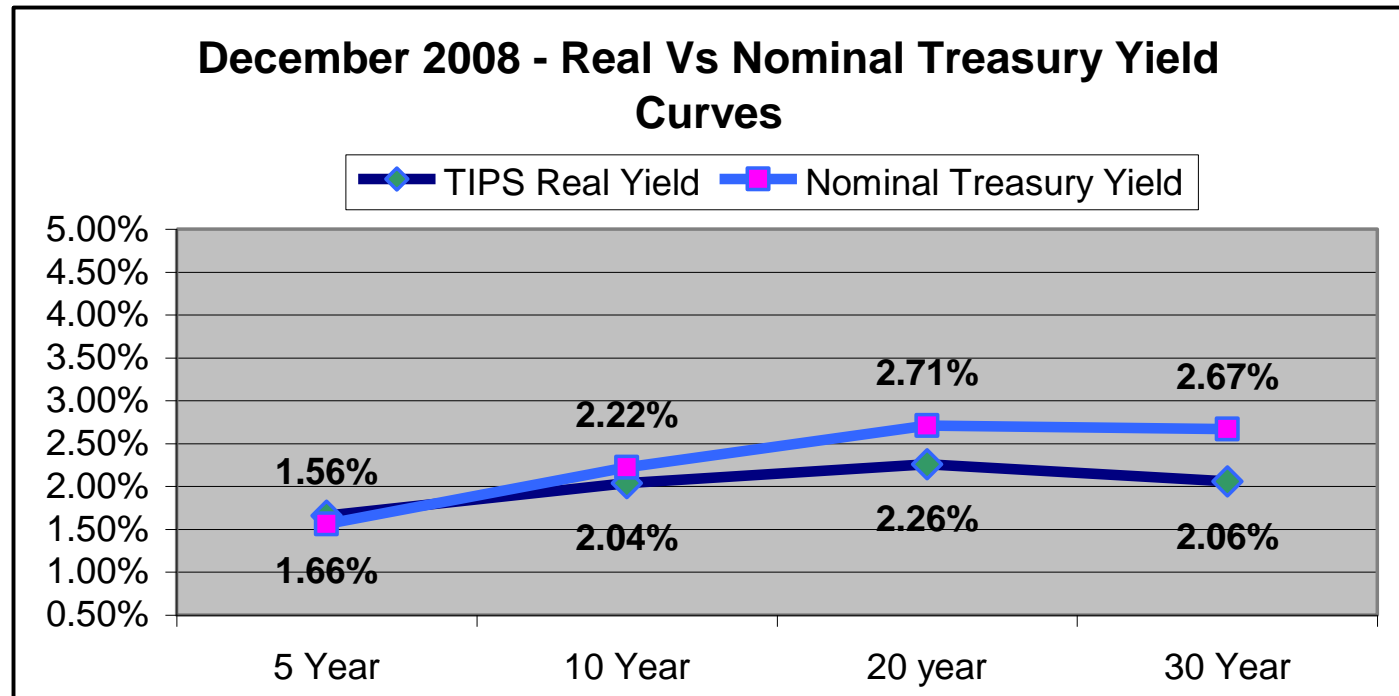
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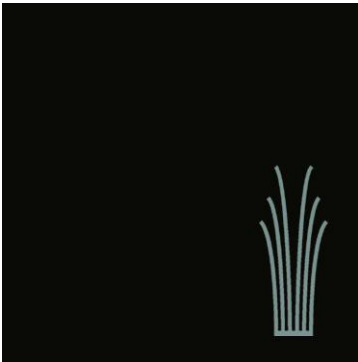
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## December 2008 – Real vs. Nominal Treasury Yields



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- *Source: Bloomberg*



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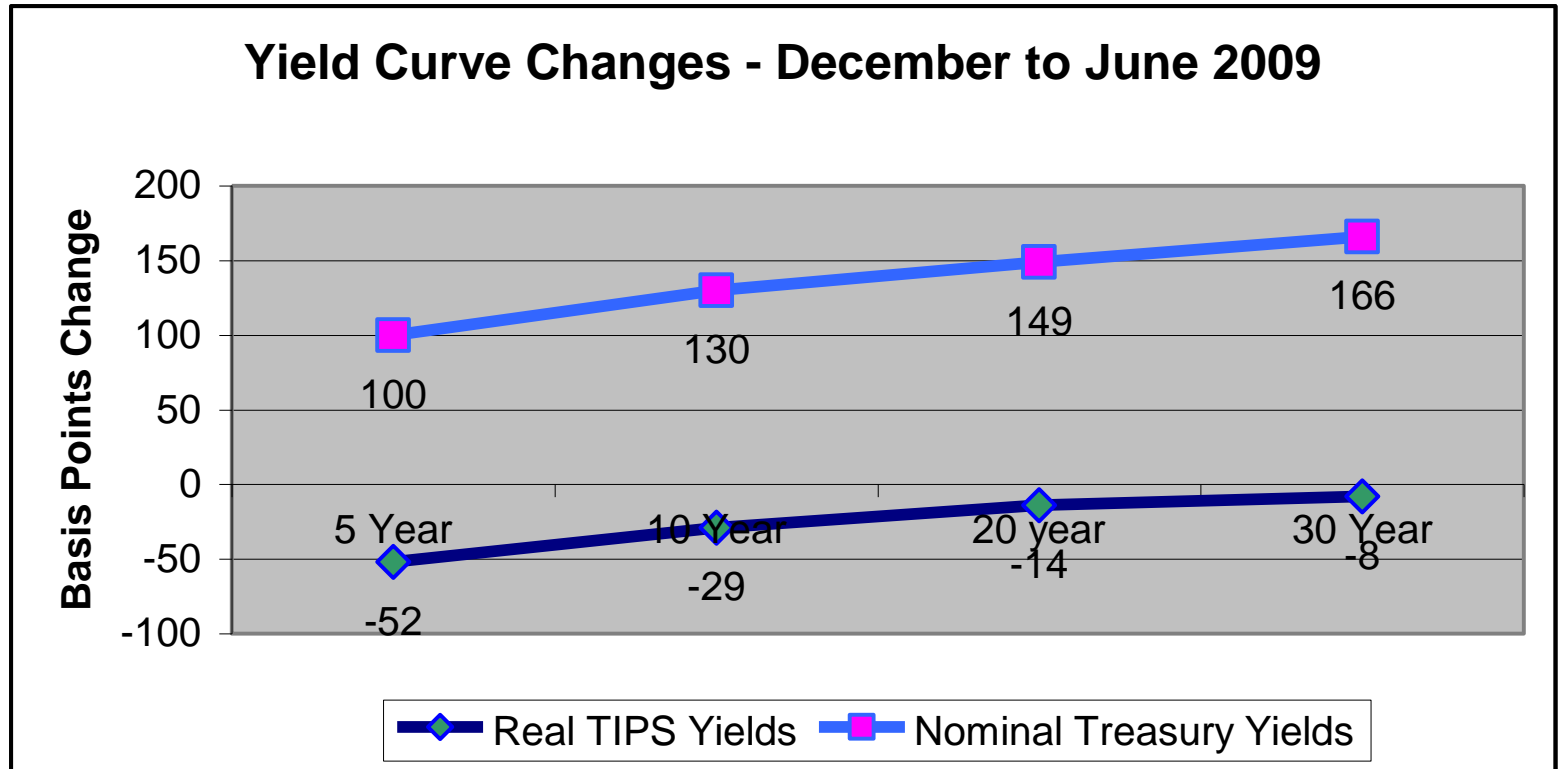
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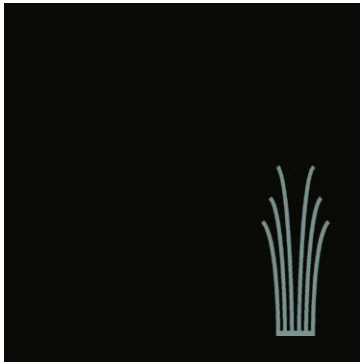
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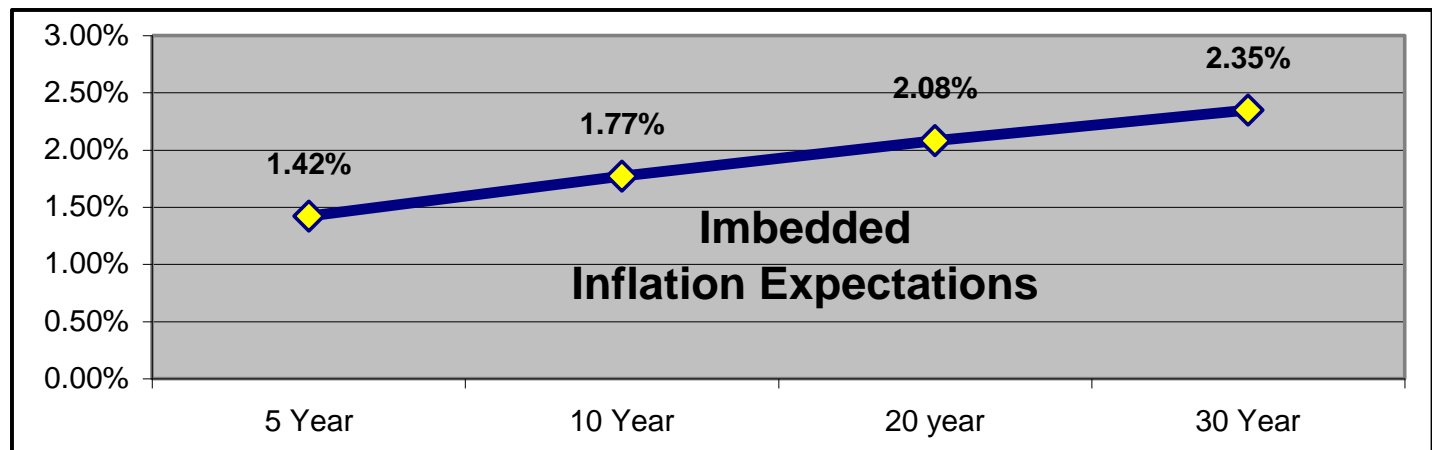
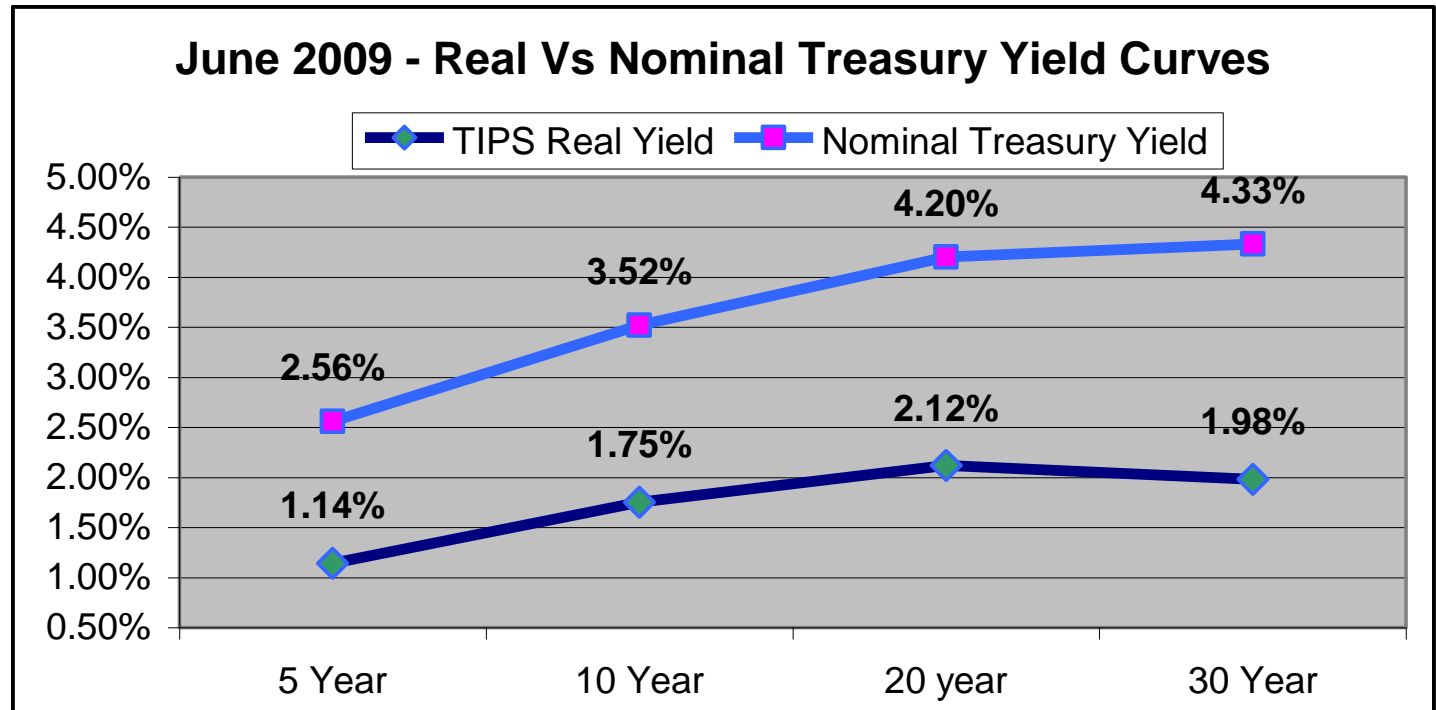
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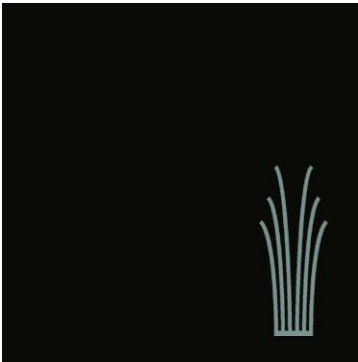
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## June 2009 View of Real & Nominal Treasury Yields



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- *Source: Bloomberg*



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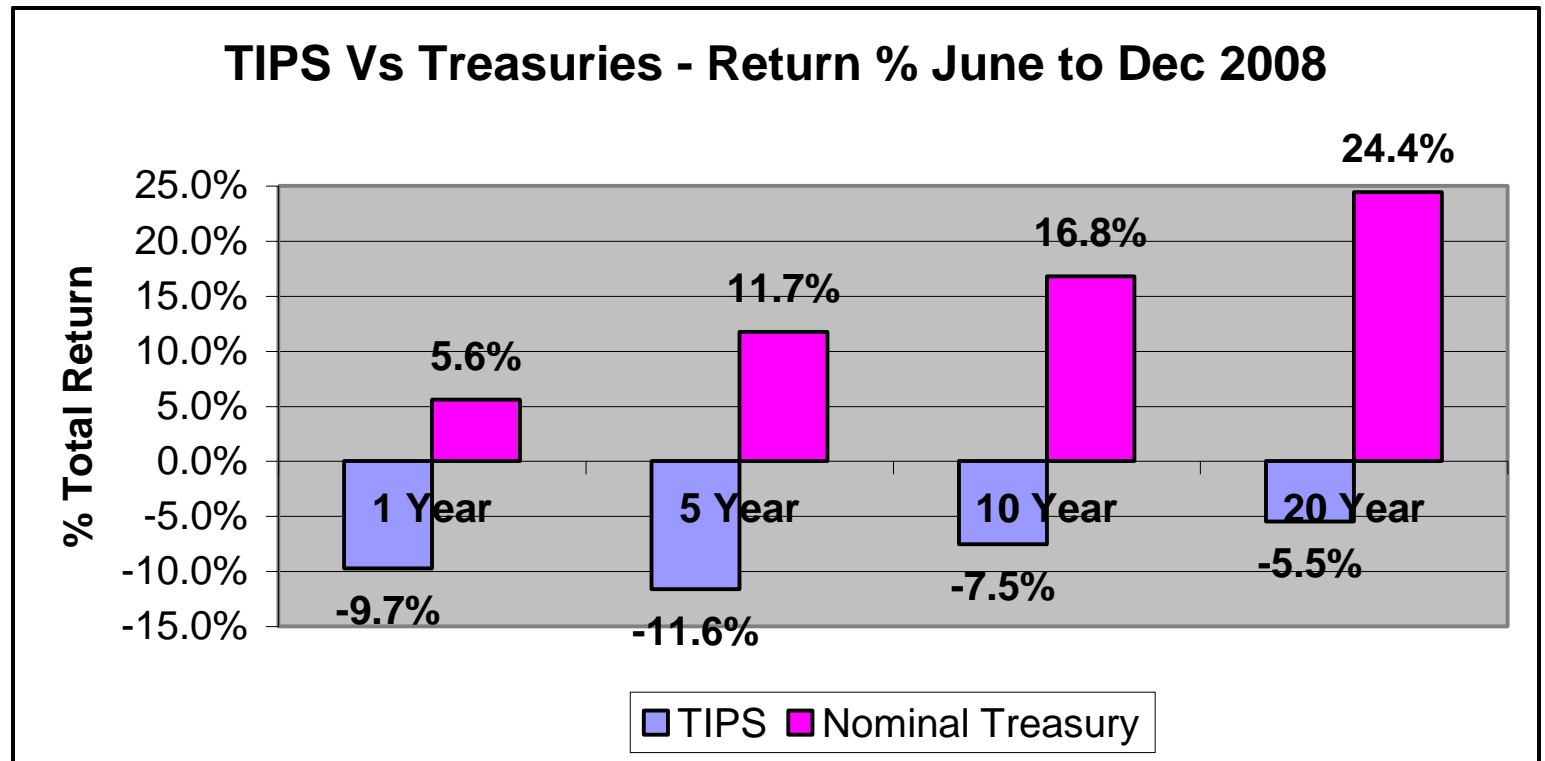
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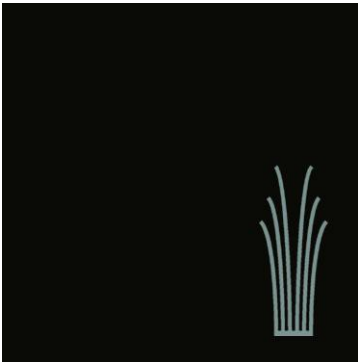
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## Total Returns- TIPS vs. Treasuries



- *Forecasts are subject to change and should not be viewed as a promise of future performance*
- *Source: Bloomberg*



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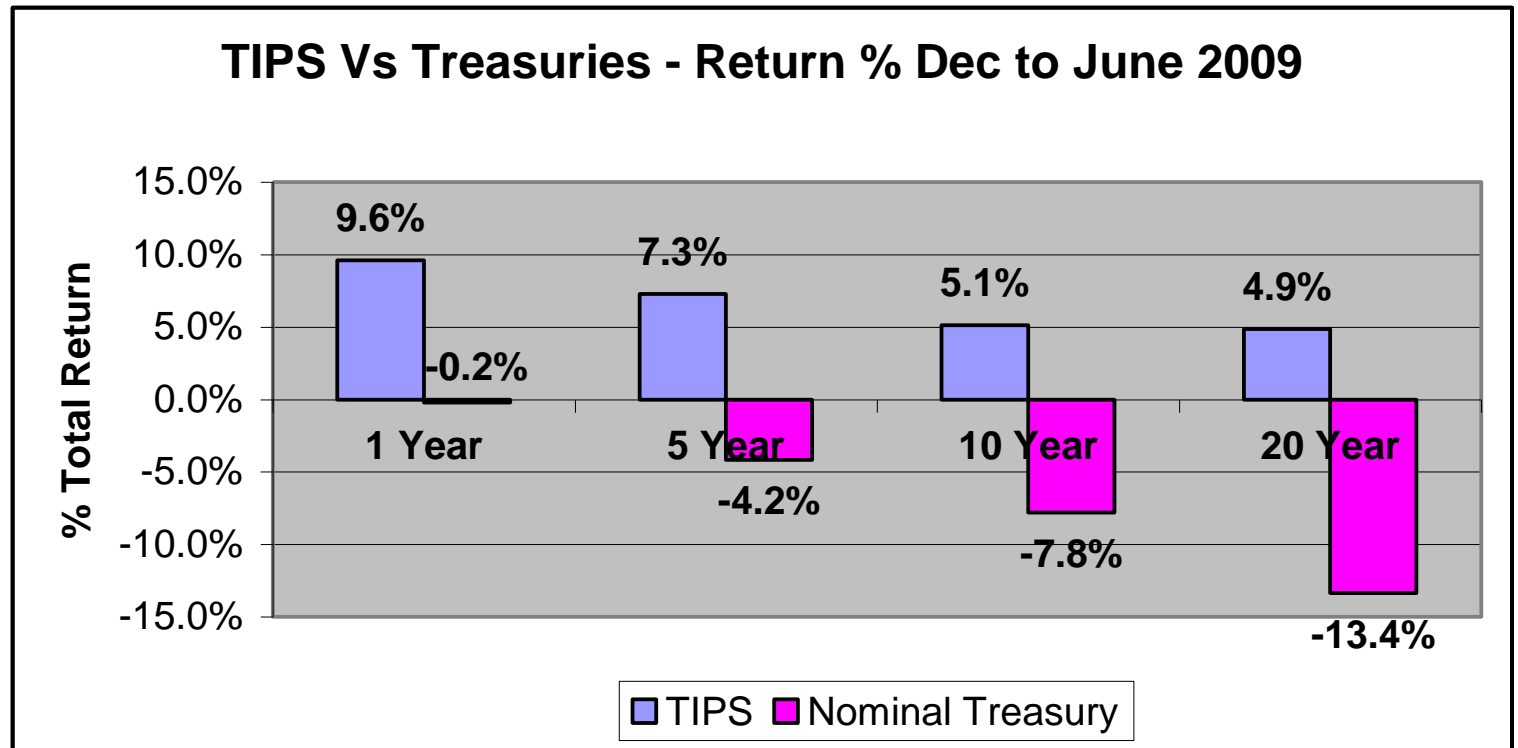
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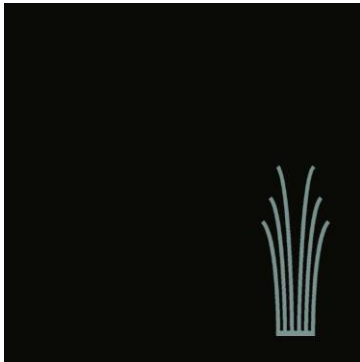
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## SKBA's U.S. Economic Scenarios

2-Year Outlook	Estimated Return Outlook			
	Inflation	Stocks	TIPS	T-Bonds
<b>Booming (0% Likely)</b>	5.0%	Happy Days Again!	<i>Best Relative Return</i>	<i>Really Ugly</i>
<b>Stagflation (40% Chance)</b>	3.5%	Not great	<b>Best Total Return</b>	Darn Ugly
<b>Historical Norm (45% Prob)</b>	2.5%	<b>Super</b>	Just Better than T-Bonds	Just Ugly
<b>Perfection Again (Ain't Happenin'!)</b>	1.5%	<i>Boom Time Again</i>	Couldn't Be Worse!	Not Good
<b>Recession (&lt;1 in 5 Odds)</b>	-0.5%	Not Good, But not So Ugly	Not as bad as 2008	<i>Bond Heaven</i>

*Outlook and returns are subject to change and should not be viewed as a promise of future performance.*

## Conclusions About TIPS – Valuable but No Panacea

- ✓ 10-Year TIPS currently only discount 1.77% annual rate of CPI Inflation. Risk of Stagflation is good for TIPS!
- ✓ Unlikely to see a recurrence of rise in real interest rates if return to recession.
- ✓ Real yields are normally less volatile than nominal Treasury yields.
- ✓ Better matches asset returns with the growth in pension liabilities due to cost inflation in wages and benefits.
- ✓ But short-term maturity TIPS returns are highly sensitive to actual CPI inflation Rate.
- ✓ Long-term TIPS returns are more sensitive to changes in inflation expectations.