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Choosing the Best Inflation Protection

By Ian Salisbury, The Wall Street Journal
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Nervous about inflation, investors are considering two government securities designed to protect against rising prices: I Savings Bonds and Treasury Inflation-Protected Securities.

Choosing between these two complex securities can be tricky. But financial advisers say recent changes make TIPS more attractive than I Bonds for those who are moderately wealthy. The reason: While I Bonds offer some tax advantages, new limits on how many I Bonds investors can buy each year make the bonds difficult to accumulate in substantial amounts.

Traditionally, "I Bonds were for savers, and TIPS were for investors," said **Jean Fullerton**, a Manchester, N.H., financial planner, who has bought both types of bonds for clients but now buys TIPS almost exclusively. Now "you can't really invest that much in I Bonds," she said. "For anyone that has a significant investment portfolio ... the only option is TIPS."

While everyone is hit by inflation, not everyone needs these bonds. Investors who own stocks already have some inflation protection because corporate profits should rise alongside prices in the long term. Values of assets such as gold also have historically kept pace with other goods.

In addition, turmoil in the credit markets has sent investors flocking to government securities of all types, pushing yields down. As a result, both TIPS and I Bonds offer investors little more than insurance against rising prices right now. I Bonds currently being sold to investors, for example, pay no interest beyond their inflation adjustment.

The government created TIPS and I Bonds about 10 years ago to help investors protect their savings against inflation. While the bonds offer slightly different mechanisms to keep pace with rising prices, the main differences stem from the fact that TIPS were modeled on Treasury bonds, and I Bonds were modeled after savings bonds.

The government auctions five-, 10- and 20-year TIPS in \$100 increments. Afterward, the bonds, which offer semiannual interest payments, trade among institutional or individual investors until they mature. While investors can sell TIPS before that date, they stand to lose money if interest rates rise. TIPS can also be bought through mutual funds.

I Bonds grow out of the government's program for savings bonds, which are targeted at smaller investors and remain popular as birthday and graduation presents. Sold in amounts as small as \$25, I Bonds earn interest for as long as 30 years, but investors don't receive these payments until they redeem the bonds.

Investors can redeem I Bonds after one year if they forfeit three months' interest. They can redeem the bonds after five years with no penalty. Because investors redeem them through the government, they don't have to worry about losing money on the bonds' face value.

Many financial advisers say the distinction they have previously weighed most often is how the bonds are taxed, with I Bonds boasting some advantages that have made them attractive even to sophisticated investors.

While both TIPS and I Bonds make regular interest payments, TIPS holders must pay federal tax on the interest they receive each year, while I Bond holders can defer paying taxes until they redeem the bonds. In addition to interest, TIPS holders must also pay federal taxes on increases to the TIPS' principal, which adjusts to keep pace with inflation.

This is a problem for many investors because, while taxes are due each year, the principal increases aren't actually paid out until the bonds mature, meaning investors have to pay the tax bills with money from some other source. Being taxed on this "phantom income" means many advisers recommend investors hold TIPS only in a tax-advantaged retirement account, such as an IRA. (I Bonds also have some additional benefits when redeemed for education-related purposes.)

"The tax implications can be a big deciding factor," said **Burt Hutchinson**, a financial planner in Lewes, Del. "The nice thing about I Bonds is that they are tax-deferred."

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