

# **Understanding Treasury Inflation- Protected Securities (TIPS)**

## **How TIPS Can Help Preserve Purchasing Power**

It's common to hear financial pundits talking about their expectations for inflation. But what does inflation mean for the average investor? It erodes your purchasing power, so the \$20 bill you have today may buy less next year. Simply put, inflation is a rise in the prices of goods and services. So what is an investor to do?

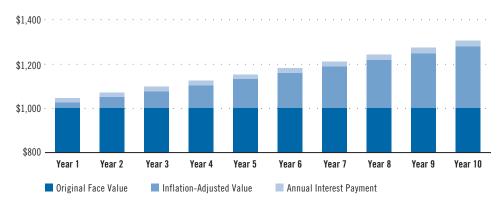
#### **INFLATION PROTECTION THAT'S TOUGH TO BEAT**

TIPS were first introduced back in 1997 by the U.S. government and are a popular way for investors to combat inflation. Like traditional Treasury bonds, TIPS are issued by the U.S. Treasury and are guaranteed by the U.S. government. But TIPS have a special feature that provides protection against inflation. The principal value of a TIPS is periodically adjusted according to the rate of inflation. In contrast, a Treasury bond's principal value is fixed.

At maturity, TIPS can be redeemed or sold at their inflation-adjusted principal amount or at par value, whichever is greater. In a deflationary environment, a TIPS investor is guaranteed par value.

#### **TIPS AT WORK**

### Growth of a Hypothetical \$1,000 Investment in TIPS over 10 Years



The chart is for illustrative purposes only and is not representative of any Franklin, Templeton or Mutual Series Fund's performance or portfolio composition. The information is not based on statistical information and assumes a 2% annual interest rate and 2.5% annual rate of inflation.

Suppose you purchase a new, 10-year TIPS with a 2% coupon for \$1,000. The initial annual interest payment is \$20. If inflation is 2.5% over the course of the year, the face value of the security would increase by 2.5% to \$1,025, and the annual interest payment would increase to \$20.50 to reflect the adjusted principal amount. If inflation held steady at 2.5% over the course of 10 years, the face value of the security would grow to \$1,280.

#### TIPS ARE SUBJECT TO INTEREST RATE RISK

Because of their inflation adjustment feature, some investors may mistake TIPS for adjustable-rate securities, whose interest rates reset periodically and which are therefore less sensitive to interest rate risk. It might be easy to confuse inflation protection with interest rate protection. The fact is, TIPS can be volatile and decline in value over the short term. This typically happens when interest rates rise. This is an important point to understand before considering an investment in TIPS or a mutual fund that invests in TIPS.

#### A WORD ABOUT TAXES

The other wrinkle associated with TIPS is how taxes are handled. The inflation adjustment of the TIPS principal amount is subject to federal tax in the year in which it occurs, even though you won't receive the adjustment until the security matures. In other words, if your \$1,000 TIPS increases in value (due to an inflation adjustment) to \$1,025, you will be liable for federal tax that year on the increase of \$25—even though you won't see that \$25 in your wallet unless you sell or redeem your TIPS that year.

However, for mutual fund investors, it's a different story. A mutual fund that invests in TIPS typically pays out any income from principal adjustments as part of its regular distributions. These distributions are taxed similarly to dividends received from other income investments.

1. Individual securities owned by a fund that invests in TIPS, but not shares of the fund, are guaranteed by the U.S. government as to timely payment of principal and interest. A fund's yield and share price are not guaranteed and will vary with market conditions.

#### **TIPS VS. TREASURY BONDS**

Treasury Inflation-Protected Securities (TIPS)	Treasury Bonds
Income generating	Income generating
Exempt from both state and local taxes	Exempt from both state and local taxes
Principal value adjusted for inflation	Principal value is fixed
Interest earned is based on inflation-adjusted principal	Interest earned is fixed
At maturity, security redeemed at inflation-adjusted principal amount or original par value (whichever is greater)	At maturity, security redeemed at original par value
Typically lower coupons than Treasury bonds	Typically higher coupons than TIPS

#### SOME TIPS ON INVESTING IN TIPS

Like traditional Treasury bonds, TIPS can be purchased directly from the U.S. Treasury. However, for the average investor, a mutual fund may offer some advantages. In addition to the aforementioned tax treatment, mutual funds also offer management by a team of professionals and additional diversification through their investment in many securities. Sales charges, management fees, Rule 12b-1 fees and other expenses are associated with Franklin Templeton mutual fund investments. These fees and expenses reduce investment returns.

## Franklin Real Return Fund May Help Protect Against Inflation

Franklin Real Return Fund may help preserve your portfolio's purchasing power in an inflationary environment by offering the potential for *real return* (total return less inflation).

Generally, the portfolio managers invest a significant portion of the fund's assets in inflation-protected securities, primarily Treasury issued.<sup>2</sup> They also have the flexibility to invest in other sectors of the markets with real return potential, including foreign debt securities, real estate investment trusts (REITs) and natural resources stocks.

Talk with your financial advisor to learn more about Franklin Real Return Fund (Class A Symbol: FRRAX).

**Risks.** All investments involve risks, including possible loss of principal. Interest rate movements will affect the fund's share price and yield. Bond prices generally move in the opposite direction of interest rates. As the prices of bonds in a fund adjust to a rise in interest rates, the fund's share price may decline. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. The fund is actively managed but there is no guarantee that the manager's investment decisions will produce the desired results. These and other risks are described in the fund's prospectus.

**Please Note:** Investors in Franklin Real Return Fund who do not reinvest income that comes from inflation adjustments may not maintain the purchasing power of the investment over the long term. Income earned depends on the amount of principal invested, and that principal may not keep up with inflation if the investor does not reinvest the principal adjustment paid out as part of the fund's income.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236, or visit **franklintempleton.com**. Please carefully read a prospectus before you invest or send money.

2. A fund that has a significant investment in TIPS is highly influenced by the TIPS market and the monthly inflation adjustments on these securities. If inflation declines, it can result in negative inflation adjustments for TIPS, and thus a negative 30-day standardized yield. In this scenario, the fund may not earn enough net investment income from its investments in TIPS to pay out a dividend.

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