

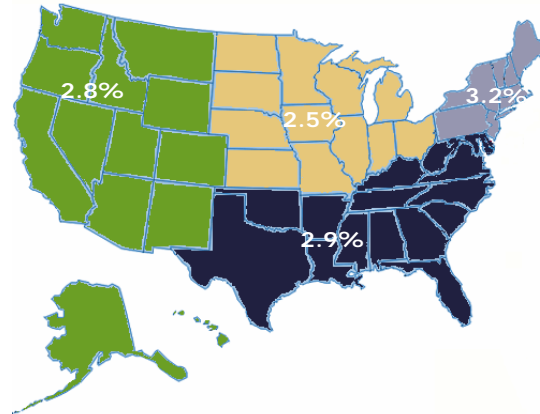
# Perspectives

## Managing Inflation Risk for Tax-Efficient Investors

June 20, 2005

Income oriented investors must be concerned not only with the absolute level of income their fixed income investments generate, but also with the degree to which their income maintains its purchasing power. Despite recent innovations in the fixed income markets, including the introduction of Treasury Inflation Protected Securities (TIPS) in 1997, there remain few viable choices for income oriented investors concerned with tax-efficiency. A close look at the structure of TIPS and their municipal counterparts (Municipal CPI bonds) helps to explain why there are no complete solutions for investors seeking to protect their buying power.

Inflation Rates Differ Across the U.S.



Source: U.S. Bureau of Labor Statistics, May 2005

Due to the unfavorable tax treatment of TIPS, they have limited appeal for clients concerned with generating tax-efficient income. TIPS' most attractive feature is the way they can potentially be used to protect a consumer's purchasing power from inflation. As the Consumer Price Index (CPI) increases, the security's fixed coupon is applied to a principal amount that grows with inflation, thus protecting the coupon's purchasing power. At maturity, an investor receives his principal amount, indexed to CPI and protected from inflation. If our TIPS story ended here, the investor's buying power would be truly protected.

Despite attractive features, TIPS lose their allure on an after-tax basis. Not only are the coupons taxed, but the increase in principal that occurs over the life of the bond is taxed as ordinary income as well – despite the fact that the investor does not receive this final cash flow until maturity. In high inflation scenarios, a taxable TIPS investor may actually have to *pay* cash each year to own the securities. In such a scenario, the tax liability created by owning TIPS exceeds the coupon cash flow received by the investor. As a result, TIPS make the most sense for non-taxable entities such as pension funds, endowments, and foundations. For a private client, TIPS are best utilized in tax deferred investment structures such as IRAs, or 401Ks.

Municipal CPI bonds (typically referred to as Muni CPI's) exist, but only a modest amount of these securities have been issued. As a result, the liquidity in this small segment of the municipal market is limited and transaction costs are higher. Compounding matters, the inflation protection provided by these securities is both limited and tends to be overpriced. While the coupon on Muni CPI's is adjusted upward for inflation, the principal returned to the investor at maturity is not. Considering that the principal of the bond represents the largest portion of a client's assets exposed to inflation risk, the absence of principal protection is a considerable structural weakness.

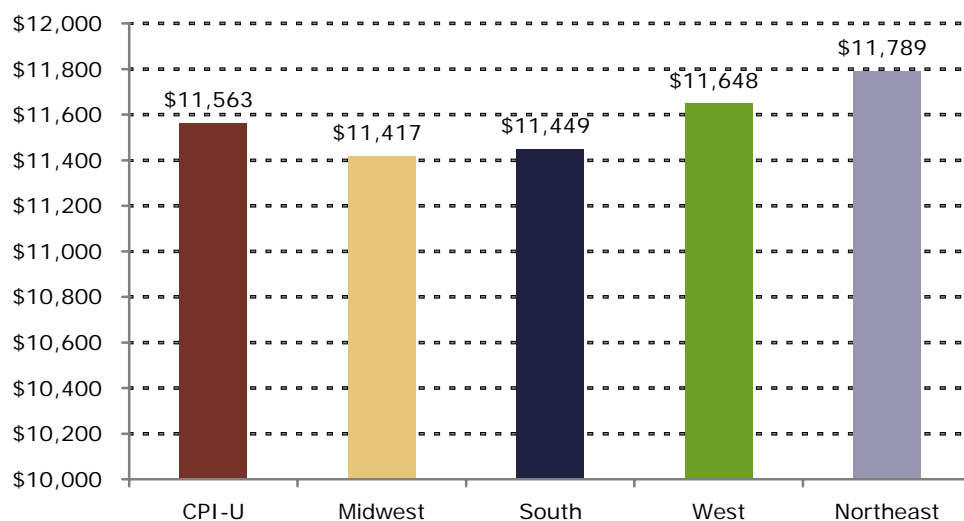
### All CPI's Are Not Created Equal

The inflation protection afforded by TIPS and Muni CPI's is based on a national consumer inflation measure which may not accurately reflect a specific investor's personal inflation exposures. Both TIPS and Muni CPI's use the national Consumer Price Index for Urban Consumers (CPI-U) to adjust coupon payments upwards (TIPS and Muni CPI's) and principal payments upwards (TIPS only) on a periodic basis. On the surface, using CPI seems both appropriate, direct, and understandable. After all, CPI reflects the national inflation rate.

The risk to investors is that the inflation rate they personally experience may diverge significantly from the inflation rate experienced by the urban consumers across the nation. The U.S. Bureau of Labor Statistics, which is responsible for calculating CPI-U, also calculates a CPI for the major regions of the United States. These regional inflation rates can vary from the national CPI-U by considerable margins.

In order to demonstrate the impact of these differing inflation rates we have gone back in time to the start of 2000 and given \$10,000 to 4 imaginary consumers - one in each region of the country. Next, we index each consumer's \$10,000 for his particular regional inflation rate. On the chart below, we show how each person's \$10,000 grows from 2000 through April 2005 when it compounds at the regional CPI rates. The final dollar amounts for each region show how much each consumer's money must grow to maintain his purchasing power. We also index \$10,000 for the national CPI-U used to calculate the principal adjustments on TIPS and the coupon adjustments on Muni CPI's. The comparisons are instructive:

### Maintaining Purchasing Power by Region: 2000 to 2005



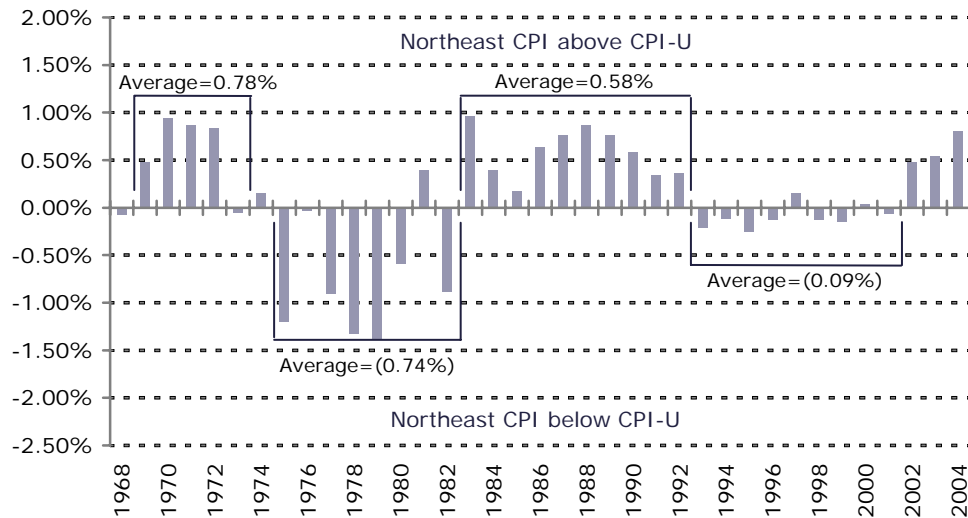
Source: U.S. Bureau of Labor Statistics, Samson Capital Advisors

A consumer living in the Northeast needs his \$10,000 to grow to \$11,789 in order to maintain his purchasing power over the period. Yet, if this consumer can only invest in a security indexed to CPI-U, his money will grow to only \$11,563. As a result, despite investing in a CPI-U linking security, this investor has lost purchasing power over the period.

Compare the experience of the Northeast consumer with the Midwest consumer. The Midwest consumer, who lives in a region with a low inflation rate, only needs his \$10,000 to grown to \$11,417 over the period to maintain his purchasing power. Yet, if the Midwest consumer invested in a security linked to CPI-U, his \$10,000 would actually grow to \$11,563. In this case, the consumer in the Midwest has enjoyed an increase in his purchasing power and benefited from an inflation arbitrage!

Intuitively, it seems reasonable that regional economies, with distinctive competitive advantages and disadvantages, will generate their own inflation rates. Yet, the divergence between regional economies and the national CPI-U over the past few years seems striking. Is it an anomaly related to the unusual turbulence of the past 5 years, or is this a typical level of divergence? The chart below compares the annual Northeast CPI to national CPI-U for the periods 1968 through 2004. *Not only does the Northeast CPI diverge from the national data, but these divergences can be sustained for extended periods.* As the data suggests, even long-term investors in CPI linked securities must develop a view on their regional inflation rate, and how the inflation they experience relates to the national CPI-U. We will discuss these divergent regional inflation rates in greater detail in future commentaries.

### Annual Inflation Rate Differential: Northeast CPI minus CPI-U



Source: U.S. Bureau of Labor Statistics, Samson Capital Advisors

CPI linked securities are an appealing concept, yet it should be clear that many issues must be considered before an investor purchases one. Investors must not only evaluate the structure and tax-efficiency of CPI linked securities, but whether or not the index used for principal adjustments will truly protect his purchasing power over the longer term. In the absence of better inflation linked securities, tax-efficient investors must rely on active investment strategies to protect their capital not only from interest rate volatility and credit risk, but also from inflation.

We look forward sharing with you our other ideas about inflation and tax efficient management in the future.

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