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Inflation-Linked Investing: Securities to Counter an Age-Old Threat

No one can predict when, and if, inflation will go up. Rather than waiting to see what happens, you can help protect your portfolio by developing a long-term strategy that includes inflation-linked bonds.

Inflation has been generally low the past several years. But uncertainty in Venezuela, the Middle East and other parts of the world continue to destabilize oil prices — something we experience regularly here at home when we fill up at the pump.

Are these events part of a long-term inflationary trend? No one can say for sure, but inflation-linked bonds can help protect your retirement assets and other investments from inflation.

The Corrosive Power of Inflation

Most people are familiar with what inflation can do — every grocery bill or car purchase offers a reminder that a dollar doesn't buy what it used to. Those who remember the 1970s may have a more vivid picture, for in just three years, from 1978 to 1981, the value of a dollar dropped by 30%. And, that's by no means the most extreme case.

In some parts of Europe after World War I, inflation was so bad that people needed wheelbarrows to carry enough currency for a few days' worth of groceries. Between January and September 1972, Argentina experienced a cost-of-living increase of 49.2%, which cut the value of people's money virtually in half in a single nine-month period.

While tighter economic controls hopefully make such extreme price swings less likely today, it doesn't take a record breaking inflation stretch to severely impact your savings. If inflation rises at the same rate in the near future as it has in the recent past, the effect on prices could still be unsettling. For example, an inflation rate of 2% over a 10-year period can result in an 18% drop in purchasing power.

Paying 41 cents for a stamp is one thing. But the thought of a significant cut in the purchasing power of your retirement savings is a daunting one.

Investing to Beat Inflation

Many types of investments can help you keep pace with, or stay ahead of, inflation. But generally, the higher the desired return, the more risk you must take. Over long periods of time, stocks have often beaten inflation, but not always — as the mid-1970's, early 1980s, and even the early part of this decade, made dramatically clear. (Also keep in mind that stocks represent the riskiest class when compared to guaranteed, fixed

income and real estate asset classes, and, of course, you should remember that past performance does not guarantee future returns.)

Real estate investments can also effectively hedge against inflation, since the cost of commercial real estate and rents is more directly related to an overall business expansion and price trends, than to one isolated economic factor. However, you need to be aware that real estate is illiquid, and that it may be slow to react to more rapid changes in inflation.

Money market accounts are short-term enough to be highly responsive to inflation, but generally do not stay very far ahead of it. And while longer-term bonds tend to provide higher returns than money market investments, they are vulnerable to current interest rate changes — the kind often created by inflation — that can reduce the value of existing portfolios.

Inflation-Indexed Securities

Inflation-indexed securities offer a valuable option — an investment specifically designed to provide a substantial and predictable real rate of return over inflation. (For example, if inflation is 3%, a 5% interest rate provides a 2% real return over inflation.)

“Linkers” — as these inflation-linked investments are sometimes called — have been available in Britain since 1981. Similar securities were then introduced in a number of other countries that were fighting inflation, including Australia, Mexico, Argentina, Brazil, Sweden, Israel, Canada, and, in 1997, the United States. All work on the same principle: They pay an interest rate based on an official inflation measure, plus a present real rate of return over inflation. The real rate stays constant no matter how much inflation swings up and down.

The U.S. government’s inflation-fighting securities are called Treasury Inflation-Protected Securities, or TIPS. Since their introduction in 1997, the U.S. Treasury inflation bond market has grown to more than \$400 billion. TIPS base their inflation component on the monthly Consumer Price Index for Urban Consumers (CPI-U), which measures the changing prices of goods and services. For new issues, the real rate over the CPI is set at periodic auctions held by the government.

In an inflationary environment, demand will almost certainly drive up TIPS prices, which then usually causes interest rates paid by new issues to drop. Both of these factors will tend to boost the value of current portfolios and make it more expensive for investors to jump in. As Steve Traum, TIAA-CREF’s fixed-income portfolio manager puts it: “The time to buy insurance is before the flood” — that is, before inflation rises dramatically.

Long-Term Inflation Fighters

Recognizing the value of inflation-linked securities for retirement investors, TIAA-CREF took a lead role in helping the government develop TIPS. We then made them available to our participants in May 1997 through the CREF variable annuity Inflation-Linked Bond Account and to the general public in October 2002 through the TIAA-CREF Inflation-Linked Bond Fund, a mutual fund. *(Because the principal invested in TIPS — the primary security in the TIAA-CREF Inflation-Linked Bond Account — is guaranteed by the U.S. government, this is a comparatively low-risk fund. However, since the fund and account continually buy and sell securities, returns may not always track the inflation rate as directly as a single inflation-linked security held to maturity. Also note that, like conventional bonds, inflation-linked bonds are vulnerable to interest rate risk.)*

In various inflationary environments — both here and abroad — the performance of these two inflation-linked bond investments can compare favorably with that of other investments, but don't make unrealistic assumptions.

In 2002, for instance, the retirement account's performance was superior to that of other investments. That anomaly resulted from a sharp decline in real interest rates, which caused a major increase in the price of inflation-linked bonds. In fact, about two-thirds of the account's 2002 performance could be attributed to the drop in real interest rates. Contrastingly, in 2006, the account returned less than 0.50%. This was due to low inflation and a price decline brought about by investors' reduced demand, as their inflation fears calmed.

"People putting their money in the inflation-linked bond investments today shouldn't be looking for huge returns. That's not what they are designed for," says Brett Hammond, managing director and head of investment strategy at TIAA-CREF. "They tend to be less volatile than other asset classes and should be used for steady, long-term real rates of return. Overall, they are very useful as a diversification tool because TIPS are fundamentally different from any type of security and can help protect people from surges of inflation, which can be especially difficult for retired people to deal with."

For a more detailed discussion on inflation-linked securities, read Brett's "Understanding and Using Inflation Bonds," a Research Dialogue, no. 73, available on the TIAA-CREF Institute Website at <http://www.tiaa-crefinstitute.org/research/dialogue/73.html>.

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