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When inflation rises . . .

How to help stabilize your retirement income.

In 2005, the winds of inflation began to blow. They started when Katrina shut down Gulf oil refineries, triggering higher oil prices. Then they lifted the cost of everything affected by energy prices, from air-conditioning and home-heating to consumer goods.

When inflation goes up, the value of your investments — *and* the purchasing power of the income you derive from them — can drop. Fortunately, Social Security provides some buffering: Benefits rise with the cost of living and will increase 4.1% for 2006. But what about the rest of your income? Can the way you manage your investments have a stabilizing effect?

Two Strategies That Can Make a Difference:

You can diversify your investments – By spreading your savings among different investments, you lower your risk of losing a lot of money if one investment sinks.

You can spread your investments among asset classes that perform differently under varying economic circumstances. Think pistons: When one goes down, another goes up. This technique is called “asset allocation.”

Keep in mind, however, that proper diversification and asset allocation can’t prevent losses or guarantee that an investor’s goal or objectives will be met.

Diversification is easy to understand, but how does asset allocation help?

Why Asset Allocation?

Including several asset classes in your income portfolio can help you avoid extreme lows — and highs — and smooth your income stream. (An asset class is a type of investment: stocks and bonds, for example.)

The following asset classes can help offset the effects of inflation. They often have little correlation to one another, reacting differently to changing economic conditions. Each asset class has its pros and cons, however.

Equities, the most volatile investment category, have historically beaten inflation over the long term.

Within equities, there are subcategories that don't closely correlate with each other. For example, during 2005, large-cap domestic stocks lagged behind mid-sized and international stocks. Stocks have trailed inflation during certain years, however — for example, 1973 – 74, 1981, 1990 and 2000 — although their performance from 1993 to 1999 was generally stellar.

Real estate can serve as an inflation hedge, since the cost of commercial real estate and rents rises with overall business expansion and prices. But because real estate is illiquid, it may be slow to respond to rapid changes in inflation. Ultimately, real estate prices reflect the general economy and prevailing interest rates.

Money market account interest rates rise quickly in response to inflation, but they exceed it by only a small margin. When rates are very low, account management fees may negate any gain.

Longer-term bonds tend to provide higher returns than money market instruments, but they are vulnerable to changes in current interest rates. When interest rates rise, returns on a bond mutual fund portfolio will fall.

U.S. Treasury inflation-protected securities (TIPS) are designed to track inflation. If inflation and interest rates rise, returns of inflation-linked bonds will rise with them. And if inflation is low or flat, returns generally will be modest.

Let's take a close look at TIPS, since they are a relatively new product.

U.S. Treasury Inflation-Protected Securities (TIPS)

TIPS are designed to provide a “real” rate of return that is higher than the inflation rate. (If inflation is 3%, for instance, a 7% rate of return provides a 4% real rate of return over inflation.) They do this through a formula that changes the value of the TIPS principle each month based on rise or fall in the Consumer Price Index for Urban Consumers (CPI-U), a measure of the changing prices of goods and services. The “real” fixed interest rate is applied to the changing (usually increasing) principle so that the payout changes with inflation.

So if you bought a \$1,000 TIPS at a real coupon rate of 3.8% in 2004, and the CPI-U rose 3% over 2004's rate, the principal on your bond would be worth \$1,030 in 2005. And you would earn 3.8 % interest on the \$1,030, so the interest you actually earn rises even though the real coupon rate remains the same. In addition, if you keep the bond to maturity, you will get back a principle amount that has also increased with inflation over the life of the bond.

If inflation heats up, interest rates tend to rise, which will depress the price of existing regular bonds, may dampen stock prices, and possibly hurt real estate sales and new construction. But returns on TIPS are designed to climb right along with higher interest rates that are caused by inflation.

After several years of spectacular returns well in excess of the coupon plus inflation, TIPS returned less than inflation during 2005. That's because real rates were rising and investors weren't particularly worried about future inflation increases, thus making the bonds relatively less desirable. Over the long run, however, an inflation-bond fund should more than keep up with inflation.

Note that unlike other Treasury securities and corporate bonds, TIPS provide for growth in principal; such growth is taxed as current income even though you don't receive the increase as cash. (The exception to this is Series I U.S. Government Savings Bonds.) The best use of TIPS may, therefore, be to hold them in a tax-deferred account or fund.

Individual TIPS Versus a TIPS Account or Fund

Individual TIPS and a TIPS annuity account or mutual fund don't behave the same way. That's because the account/fund invests in a pool of bonds, which is actively traded. The account follows market prices and won't always track inflation as directly as individual bonds. An individual TIPS that you bought and held to maturity wouldn't be affected by market prices. Note that owners of a fund owe management fees; owners of individual bonds incur transaction fees.

The chief advantage of a TIPS account/fund is that you don't have to manage your own TIPS portfolio. Professional managers can do this for you to minimize the risks associated with selling and buying bonds or rolling them over into new issues.

TIAA-CREF offers TIPS products, including the TIAA-CREF mutual funds' Inflation-Linked Bond Fund. For information on TIPS and help with adjusting your income portfolio to hedge inflation risk, call **800 842-2776** and speak with one of our consultants. Or visit www.tiaa-cref.org for specific TIPS product information. Read the prospectus carefully before investing.

Inflation During Your Retirement Years

If you retire at 65 and die at 90, you must weather 25 years of inflation. If inflation remains modest — averaging only 3% per year — then after 25 years, one dollar of income you receive will be worth only 47 cents.

That's why we advise people who can tolerate some fluctuation in their retirement income to draw a portion of it from stocks, bonds and real estate — not just from a fixed-interest or guaranteed annuity product. Although performance can fluctuate, these types of investments can help counter inflation's effects in the long run, and each one performs a little differently in helping preserve your buying power.

For a Portfolio Check-Up . . .

Our consultants can help you evaluate the appropriateness of your income portfolio and select the right investments for your goals and risk tolerance. For your retirement savings, call **800 842-2776**. For TIAA-CREF Mutual Funds, call **800 223-1200**. If you're interested in individual

bonds and the 6,500-plus mutual funds available through TIAA-CREF Brokerage Services, call **800 842-2776** and press *8, or visit us on the Web, www.tiaa-cref/brokerage.

Know

Do Budget Deficits Influence Inflation?

The U.S. Government has a high budget deficit, but there is little danger that it will increase inflation. The impact of a country's deficit depends on the extent of central bank "monetization."

Monetization occurs when a central bank, like the Federal Reserve, buys government debt (generated by deficits) with newly created "high-powered money"—that is, increased central bank liabilities in the form of currency or bank reserves. Inflation may rise with increased monetization, especially when it is extreme, for example, if the central bank finances a large portion of the deficit.

Indeed, hyperinflation (very high inflation rates) has occurred historically when central banks have chosen to monetize government deficits aggressively, such as Brazil, Argentina and Mexico. During the 1980s, many Latin American central banks, under political pressure, continued to monetize a large portion of budgetary deficits, resulting in continued high rates of inflation. But, during the 1990s, as central banks in the region gained increased political independence, the degree of central bank monetization diminished sharply. As a result, inflation rates in the region fell dramatically, with just single-digit rates of inflation being registered in those countries today.

In the United States and Europe, the inflationary impact from deficits is likely to be quite small. Central banks in those areas, all of whom are independent, have shown no inclination to aggressively monetize deficits. Furthermore, some central banks in those areas (the European Central Bank, the Bank of England, for example) are constrained by formal inflation targets. As a result, it is very unlikely that budget deficits will be monetized there. Without monetization, the inflationary impact of deficits is likely to be subdued.

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