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ASK ENCORE**Rising Interest Rates and TIPS in Your Portfolio**By **KELLY GREENE**

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We are a retired couple who hold about 50% of our investments in TIPS. How do these securities generally act when interest rates begin to rise?

--R.C. Soskis, New Hyde Park, N.Y.

Treasury inflation-protected securities, or TIPS, as they are often called, are designed to provide protection against inflation.

Here's how they work: The principal increases with inflation and decreases with deflation. The government uses changes in the Consumer Price Index as the benchmark. Twice a year, interest is paid -- at a fixed rate -- upon the adjusted principal.

Tom Adams, a financial planner and certified public accountant in Elmhurst, Ill., walked us through an example: Let's say you bought a \$1,000 TIPS on July 31, 2007, with a five-year maturity that paid 4.625% annual interest. Let's also say that the inflation adjustment used to adjust the principal's underlying value was 2%. That means that for the six months ending Jan. 1, the principal's value would be increased by 1%, or \$10, to \$1,010. And the interest paid on the inflation-adjusted amount would be 2.3125%, or \$23.36.

There's also the matter of the overall interest-rate environment and how that would affect your TIPS. If you hold them to maturity, the overall interest-rate environment wouldn't affect their value at all because you're guaranteed the same interest rate for the life of the TIPS.

But if you want to sell them before then, interest rates might affect the value of your TIPS. "Generally, when interest rates go up, the value of a bond goes down," Mr. Adams says. "With this five-year TIP paying 4.625%, if rates were to go up and someone could get TIPS paying a higher rate, you'd have to discount them to sell them [before maturity]. Why would someone pay face value for your TIPS when they could get new TIPS paying 5.15%?"

TIPS typically make the most sense as a small part of a well-diversified portfolio, says Rick Brooks, a certified financial planner in Solana Beach, Calif. Yes, the securities provide you with a hedge against inflation -- but only as inflation is defined by the Consumer Price Index. "I would caution [against] relying solely on an inflation-hedged investment that hedges out one form of inflation," says Mr. Brooks. "You really want to build in broader inflation protection through equities, real estate and commodities investments."

One other thing to keep in mind: It's best to keep TIPS in a tax-deferred account, such as an individual retirement account, because you would owe tax on both the interest income and any increase in principal due to inflation -- even though you don't receive any increase in principal until the TIPS mature or are sold.


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