#1-1A

EASY INTERMEDIATE HARD

CFA® SAMPLE QUESTION – LEVEL I

Alternative Investments

Q: Which of the following description about Treasury Inflation protection securities (TIPS) issued by the US Department of Treasury is correct:

CORRECT ANSWER:

ⓓ **NO fixed coupon payment amounts** **NO fixed par value**

With normal (or nominal) fixed-income investments, investors bear inflation risk in that the purchasing power of interest payments could be eroded by inflation over and above their original expectations.

TIPS, however, are guaranteed to keep pace with inflation as defined by the Consumer Price Index (CPI). This is what makes them unique and defines their behavior.

For example, assume a $1,000-U.S. TIPS was purchased with a 3% coupon; also assume inflation during the first year was 10%. If this were the case, the face value of the TIPS would adjust upward by 10%, to $1,100.

Furthermore, the coupon payment (3%), which is also based on face value, would be $33 (payments adjust and are paid semi-annually). The end result is that not only are interest payments protected against inflation, but so is the bond's face value, which is returned to the investor at maturity. Traditional nominal bonds offer neither of these protections.

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