

What is Inflation and how does it affect investments?

Inflation is a sustained rise in the general level of prices for goods and services. Inflation poses a challenge for all investors, especially the holders of fixed income investments, because the effects of rising inflation can erode the real value and purchasing power of interest payments, which are typically fixed over the life of an investment. If an investor's living expenses increase over time due to strong inflation, but the fixed return of a bond portfolio does not increase, the resulting gap could impact an investor's living standard. For investors who rely on the stability and predictability of fixed income investing, finding ways to limit or mitigate the effects of inflation are crucial for ongoing financial success.

Inflation linked investments pay interest based upon changes in the Consumer Price Index (CPI). This is done through either adjustments in the principal amount on which interest payments are based, or adjustments to the interest rate. There are several varieties, with varying features. Inflation protected securities offer a trade off between lower nominal returns in exchange for an increased income stream as inflation grows. If inflation remains low or declines, these investments will tend to under perform investments without inflation protection features. Below are four general examples of inflation protected securities.

U.S Treasury Inflation-Indexed Securities (TIPS)

TIPS are issued by the U S Treasury in 5-year, 10-year and 30-year maturities. A 20-year maturity is expected in the near future. The principal amount of TIPS is adjusted on a daily basis for changes in the level of inflation, however, the inflation adjustment is not payable until maturity. The index used for determining the adjustment is the non-seasonally adjusted Consumer Price Index – Urban Consumer (CPI-U), published monthly by the U.S. Department of Labor. The rate used for the TIPS principal adjustment lags the index release by 3 months. For example, the CPI applicable to April 1 in any calendar year is the CPI published for January. This adjustment is expressed using a factor. If the CPI has increased by 15% since original issuance, then the factor is 1.15 and the inflation-adjusted principal amount is \$1,150 for each \$1,000 at issuance. At maturity the security will be redeemed at the greater of its inflation-adjusted principal amount or the principal amount of the securities on the date of issuance. Interest is paid every six months. The payment is determined by multiplying the coupon rate of the issue by the inflation adjusted principal amount.

Key Features

- **High Credit Quality.** Treasury inflation indexed securities are direct obligations of the United States government and are backed by the full faith and credit of the federal government.
- **Liquid Secondary Market.** There are many primary dealers that make active secondary markets in TIPS. TIPS are available in multiples of \$1,000. The market value will fluctuate based on general supply and demand for these securities.
- **Taxation.** Interest on TIPS is subject to federal income tax, but is exempt from state and local income taxes. Investors will also be taxed on the annual inflation adjustment to the principal in the year in which the adjustments occur, even though the principal adjustments will not be received as income until maturity. This *phantom taxation* may make these investments more appropriate in tax protected accounts such as retirement plans.

Inflation Protected Corporate Notes (IPCNS)

These are corporate bond issues with an inflation adjustment feature. Usually offered as new issues, they are occasionally available in the secondary market. Examples of the issuers include Household Finance (A1/A) and John Hancock Life Insurance Company (A1/AA). Unlike TIPS, where the principal amount adjusts, IPCNS feature an adjustment of interest. The monthly interest payment is equal to the total of a stated rate (usually in the 1.75% to 2.25% range) and the 12 month change in the CPI-U on a lagging 3 month basis. A recent John Hancock issue featured 1.8% for the stated rate. The CPI-U increased by 2.29% in the 12 month period ending 3 months before issuance, so the coupon rate for the first month was 4.09% (1.80% + 2.29%).

Key Features

- **Monthly Interest Payments.** Interest payments include a fixed portion set at the time of issuance as well as an inflationary component.
- **No Phantom Tax.** Interest is subject to federal, state and local income taxation, but there is no phantom tax, since there are no principal adjustments.
- **May Include a Death Put.** Certain issues contain an estate feature whereby the estate can sell the bonds back to the issuer at par upon the death of the holder. Limitations may apply.
- **Zero Percent Rate Floor.** If the CPI-U index declined, the actual rate paid could be lower than the stated rate, but can be no lower than 0%.
- **Varying Credit Quality.** The credit quality of these notes is based on the credit quality of the underlying issuer. These are not government guaranteed as are TIPS and are not FDIC insured as is the case with the next two securities mentioned in this report.

Certificates of Deposit Inflation-Protected (CDIPS)

CDIPS, like TIPS and IPCNS, use the non-seasonally adjusted Consumer Price Index-Urban as a reference to measure inflation. On each semiannual interest payment date, the base amount on which interest is paid is adjusted to reflect the change in CPI-U since the previous interest payment date, on a 3 month lag. The 10-year maturities typically have a stated rate of about 2%. Semiannual interest is determined by applying the stated interest rate to the inflation-adjusted base. At maturity the investor will receive additional interest equal to the amount by which the inflation-adjusted base exceeds the amount invested at issue. CDIPS are designed to be held until maturity, but there is a secondary market that gives the investor the opportunity to sell the security at the prevailing market value, which may be more or less than the original purchase amount. In many respects CDIPS are similar to TIPS.

Key Features

- **FDIC Insured.** Principal and interest are backed by FDIC insurance in the amount of up to \$100,000 per investor.
- **Taxation.** Interest on CDIPS is subject to federal income tax, as well as state and local income taxes. Investors will also be taxed on the annual inflation adjustment to the principal in the year in which the adjustments occur, even though the principal adjustments will not be received as income until maturity. This **phantom taxation** may make these investments more appropriate in tax protected accounts such as retirement plans.
- **May Include a Death Put.** Certain issues contain an estate feature whereby the estate can sell the bonds back to the issuer at par upon the death of the holder. Limitations may apply.

Inflation Product	CPI Principal Adjusted	Fixed Coupon	Phantom Tax	Estate Feature	FDIC Insurance
TIPS	YES	YES	YES	NO	NO
IPCNS	NO	NO	NO	*YES/NO	NO
CDIPS	YES	YES	YES	YES	YES
IFCDS	NO	NO	NO	YES	YES

*(Estate Feature Availability Depends on Individual Issue)

Inflation-Floater Certificates of Deposit (IFCDS)

IFCDS operate more like the corporate notes mentioned above. They pay a monthly coupon that changes or "floats", based on the change in CPI over the past year. The stated rate (recently about 1.8% for a 10-year maturity) is added to the change in the CPI-U over the last 12 months, on a 3 month lag. At maturity, the initial investment is returned to the investor without any inflation adjustment.

Key Features

- **FDIC Insured.** Principal and interest are backed by FDIC insurance in the amount of up to \$100,000 per investor
- **Monthly Interest Payments.** Interest payments include a fixed portion set at the time of issuance as well as an inflationary component.
- **No Phantom Tax.** Interest is subject to federal, state and local income taxation, but there is no phantom tax, since there are no principal adjustments.
- **May Include a Death Put.** Certain issues contain an estate feature whereby the estate can sell the bonds back to the issuer at par upon the death of the holder. Limitations may apply.
- **Zero Percent Rate Floor.** If the CPI-U index declined, the actual rate paid could be lower than the stated rate, but can be no lower than 0%.

Final Comments

Investors who are concerned about the impact inflation may have on their investment portfolio should consider allocating a portion of their assets to inflation-protected products. Depending on investment objectives and risk tolerance, there may be other securities or investment allocation approaches which can address issues surrounding inflation. For example certain mutual funds may invest in TIPS or follow inflation protection strategies. Your Janney Montgomery Scott Financial Consultant can help you identify the strategy and securities appropriate to your investment profile.

All of the securities mentioned in this report are subject to market risk, interest rate risk, liquidity risk and to varying degrees credit risk. The prices will fluctuate based on market conditions, and the securities may be worth more or less than the initial investment upon maturity or if sold prior to maturity. They will tend to under perform similar securities, without inflation protection features, if inflation is moderate or if the rate of inflation declines. Contact your Financial Consultant for more information.

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