

Exchange Traded Funds (ETFs) that track Treasury Inflation-Protected Securities (TIPS) have grown in popularity as investors seek a total-return vehicle with the potential to protect their investments from the negative effects of inflation. While individual TIPS offer the certainty of a coupon payment and a final maturity date, TIPS mutual funds and ETFs can offer several other advantages to investors, including flexibility, diversification and automatic reinvestment. Distributions from TIPS funds, however, can be different than payments from individual TIPS, and investors should fully understand the details. See **Glossary of Terms** on reverse.





TIPS Explained

TIPS adjust in value with changes in the rate of inflation. As it relates to TIPS, inflation is measured by the not seasonally adjusted (NSA) Consumer Price Index for All Urban Consumers (CPI-U) and is reported monthly by the Bureau of Labor Statistics (BLS). Like U.S. Treasury bonds, individual coupon and principal payments on TIPS are backed by the full faith and credit of the U.S. government. Their principal value, however, adjusts upward or downward as inflation rises or falls. As a result, because the coupon rate is applied to the adjusted principal value, the amount of coupon income paid by an individual TIPS can vary. At maturity, the investor receives the greater of the inflation-adjusted principal or par.

The Schwab U.S. TIPS ETF™ and the Calculation of Distributions

The Schwab U.S. TIPS ETF™ (ticker: SCHP) tracks the Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index (Series L), which comprises more than 30 individual TIPS. The distribution payment for TIPS ETFs in general, and the Schwab U.S. TIPS ETF specifically, are calculated based on the CPI-U. Although the majority of TIPS ETFs, including the Schwab U.S. TIPS ETF, intend to pay monthly distributions, there have been several months in which negative changes in the CPI-U have resulted in no distribution payments.

To illustrate how and when this situation can occur, as well as to better understand the framework and timing of distributions of the Schwab U.S. TIPS ETF, we provide the following examples.

	INFLATION RISES		INFLATION FALLS
Month 1	The change in the inflation from the previous month is positive .	 Change in CPI-U	The change in inflation from the previous month is negative .
Month 2	The BLS releases official inflation results for Month 1. As a result, the principal value of individual TIPS is adjusted upward , effective in Month 3.	 Change in principal value	The BLS releases official inflation results for Month 1. As a result, the principal value of individual TIPS is adjusted downward , effective in Month 3.
Month 3	Interest income is accrued by the fund and is evaluated, less expenses and other adjustments, for distribution in Month 4.		Interest income is accrued by the fund and is evaluated, less expenses and other adjustments, for distribution in Month 4.
Month 4	The fund issues a distribution payment, based on the Month 1 positive change in inflation.	 Distribution payment issued	Due to the negative change in inflation in Month 1, the fund does not issue a distribution.
			 No distribution payment issued

Note: These examples are hypothetical and for illustrative purposes only. There are cases in which a decline in the CPI-U can result in a net distribution, as well as cases in which a rise in the CPI-U can result in a zero distribution, depending on the degree of change in the CPI-U and the coupon rate of the fund's underlying securities. For further information, consult a tax professional.

What Investors Should Know

In addition to the above scenarios, which don't take the effect of interest rate changes on prices into consideration, TIPS lose value as interest rates rise, like Treasuries and other fixed-income instruments. Unlike Treasuries, however, principal-adjusted coupon income on TIPS have the potential to compensate for that drop in value when the increase in interest rates is accompanied by an actual increase in the rate of inflation. In such cases, however, the increase in income may not be sufficient to overcome the loss in the investment's value.

The Schwab U.S. TIPS ETF may be appropriate for investors seeking a diversified, total return vehicle with the potential for protection from the negative effects of inflation over the long term. Over the short term, however—particularly during periods of sharply rising interest rates or declining inflation—there is the potential not only that it may pay no distribution, but also that its value can decline.

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GLOSSARY OF TERMS

Coupon, Coupon Rate—The fixed annual rate of interest paid until maturity by the issuer of a bond. This amount paid is paid twice a year and is called the coupon income or coupon payment.

Treasury Inflation Protected Security (TIPS)—A treasury security backed by the U.S. government whose principal adjusts for inflation as measured by the NSA CPI-U. The interest payment is calculated based on the inflated (adjusted) principal. At maturity, the inflated principal or original principal is paid, whichever is greater.

Consumer Price Index for All Urban Consumers (CPI-U)—Measures the change in weighted average prices for a basket of goods and services purchased by urban consumers and used to identify periods of inflation or deflation.

Principal—The face value of a bond or par value, that is, its value on maturity.

Not Seasonally Adjusted (NSA)—Does not smooth out the data to account for seasonal variation in prices related to the change in weather, production cycles, holidays, or sales.

Inflation-Adjusted Principal—For a TIPS, the principal value increases/decreases with increases/decreases in the NSA CPI-U. The result is the inflation-adjusted principal value.

Principal-Adjusted Coupon Income—Coupon income of a TIPS reflecting cumulative increases/decreases in the NSA CPI-U multiplied by the fixed coupon rate.

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TIPS generally have lower yields than conventional fixed rate bonds and will likely decline in price during periods of deflation, which could result in losses.

The fund's yield is adjusted monthly based on changes in the rate of inflation and these changes can cause the yield to vary substantially from month to month.

Fixed-income securities are subject to increased loss of principal during periods of rising interest rates.

An investment in the ETF is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Price and investment return will fluctuate with market conditions and interest rates. Shares, when redeemed, may be worth more or less than their original cost. Government backing applies only to the government-issued bonds that make up the fund, not the fund itself. TIPS generally have lower yields than conventional fixed-rate bonds and will likely decline in price during periods of deflation, which could result in losses.

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Investment comparisons are for illustrative purposes only and are not meant to be all-inclusive. An ETF holds a basket of bonds and is therefore more diversified than an individual TIPS bond. ETFs have underlying fees and expenses that may reduce returns.

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