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What to watch

TIPS have been challenged lately

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If you're worried about inflation, you've probably thought about investing in TIPS — Treasury Inflation-Protected Securities. And if you have invested in funds that invest in TIPS, you're probably wondering why they have had such tiny returns the past 12 months.

In fact, TIPS funds have done an excellent job, and have not only whipped inflation, but dropkicked it into the swimming pool.

TIPS are issued by the federal government, and their returns come in two parts. The first is a small interest payment. The second is an addition to your principal, based on the consumer price index. The payment is based on the so-called headline CPI, which includes food and energy. Your interest payments are based on the new higher price of the bond.

The CPI has gained 1.7% the 12 months ended August, the latest data available. The average TIPS fund has gained 4.8% in the same period, says Lipper, which tracks the funds. Why the big disparity between the CPI and the funds?

Basically, this: TIPS are bonds, and bond prices rise when interest rates fall. The bellwether 10-year Treasury note yielded 2.70% at the end of August 2013 and closed August 2014 at 2.34%. TIPS didn't gain as much as other bonds, because inflation remains muted — thanks to steadily dropping energy prices.

If you're betting on higher inflation, and particularly higher oil prices, TIPS might make some sense. But remember that higher inflation means higher rates — and that will limit TIPS gains, too.