Inflation Bond

Inflation bonds are bonds where the principal is indexed to inflation or deflation on a daily basis in terms of a reference index, such as Consumer Price Index (CPI). The CPI is the proxy for inflation that measures price changes in a basket of goods and services.

The main idea of inflation bonds is that investing in the bond will generate a certain real return. Inflation bonds pay a periodic coupon that is equal to the product of the daily inflation index and the nominal coupon rate.

Therefore, even though the nominal value of the coupons and principal may change, the real return of these remains the same. Unlike regular (nominal) bonds, inflation bonds assure that your purchasing power is maintained regardless of the future rate of inflation.

An inflation bond is designed to hedge the inflation risk of the bond. Since inflation bonds offer investors a very high level of safety, their coupons are typically lower than high-yield bonds. It is an important vehicle for investors whose liabilities indexed to changes in inflation or wages.

Inflation bonds have favorable performance and lower volatility relative to other risk assets. It is favorable to retirement planning and pension funds given its inflation protection. Inflation bonds are less liquid than regular bonds. This presentation provides an overview of inflation bond product and valuation.

Reference:

https://finpricing.com/lib/EqBarrier.html