Buy Bonds? I Bonds, That Is

Nine Percent-plus U.S. Treasury-guaranteed Returns are Turning Heads

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WITH INFLATION SOARING and interest rates rising, many investors are wondering if it's time to buy U.S. savings bonds, and more specifically, I bonds. As with most things, the short answer is "maybe."

WHAT ARE I BONDS?

I bonds are a version of U.S. Government-backed savings bonds that have been around since Franklin Roosevelt signed legislation creating "baby bonds" in 1935. However, as opposed to earning a static interest rate, I bonds adjust for inflation. In theory, they compensate investors who loan money to the U.S. Government by paying inflation-adjusted interest.

However, it's not that simple. There's no guarantee of a high interest rate for the life of the bond; rather, they pay a fixed rate plus an adjustment every six months based on the increase or decrease in the consumer price index (CPI). As of the writing of this article, the opening interest rate for an I bond is a whopping 9.62 percent.

The bonds themselves are available in $50, $100, $250, $500 and $1,000 denominations, and can be purchased online at treasurydirect.gov. They are also accompanied by a couple of tax benefits: They are exempt from state income taxes, though you will owe federal tax when you surrender the bond; they are federally tax-free when cashed if used to finance education.

BUT I BONDS HAVE ISSUES.

Why not put a huge chunk of money into a 9.6 percent U.S. Government bond? One reason revolves around the formula of the combination of a fixed rate and a CPI rate that is reset every six months. The fixed rate is currently zero percent, in essence, an

interest-free loan to the government. When the CPI rate is high as it is currently, I bonds look great, but as that rate declines — and it will — I bond investors will be left with progressively lower yields. As an example, the current 9.6 percent rate is comprised of 0 percent Fixed Rate + 9.6 percent CPI Rate.

OTHER ISSUES WORK TO DISFAVOR I BONDS FOR THE AVERAGE INVESTOR:

- Maximum issue amounts are $10,000 per taxpayer per year electronically, and $5,000 in paper bonds. If you try to move more than the maximums into the bonds, your attempts will be rejected and it could take three-to-six months to process your refund — in essence, another interest-free loan to your government.
- The bonds are technically 30-year notes. Holding a zero-interest bond is neither appealing nor wise.
- If inflation eases, your interest rate is going to decline every six months as other interest rates may rise to curb inflation.
- In theory, you can always redeem I bonds, but you are required to own them for at least one year, and if you redeem them prior to five years, you forfeit the previous three months' interest, further reducing your real return, even if inflation remains high.

BACK TO THE FUTURE

Perhaps if you had the foresight — and patience — to accept a negligible I bond return for the past two decades, you would now be enjoying the returns. Buyers putting $10,000 per year into I bonds from 1998 to 2000 would have owned bonds with a fixed rate of 3.5 percent plus the CPI rate. Considering the current CPI rate of 9.62 percent, their I bonds would be earning 13.12 percent today. Even if the CPI is reduced to zero percent, they would still be earning 3.5 percent. That's an excellent bond yield today, but it wasn't in 1998 when 10-year Treasuries were paying 5.5 percent and corporate bonds even more. So you would have endured more than two decades of under performance.

WHAT ABOUT **TIPS**?

Unlike the $10,000 per year maximum investment in I bonds, you can invest up to $5 million in Treasury Inflation Protected Securities (TIPS). They also come in varying maturities and like I bonds pay out an inflation-adjusted return. Essentially, the principal rises and falls with the CPI; the base rate remains fixed but the amount of interest changes based on the CPI-adjusted value of the bond.

But TIPS also have unattractive characteristics. First, the bond interest is taxed annually. Worse, there isn't much yield; the 30-year TIPS in the latest auction carried an interest rate of 0.125 percent. Additionally, TIPS are generally not redeemable; they are salable but there is little market for a 0.125 percent 30-year bond and as such getting much if any premium for them could be challenging.

You might think the iShares TIPS ETF is performing well considering recent inflation data. But year-to-date performance as of May 16 was –6.27 percent; the trailing 12-month

return was –1.66 percent. This is better than the average bond fund, the simple fact is it's a far cry from I Bonds. Bottom line: While the availability and usability of TIPS are superior to I bonds, their returns don't measure up in comparison to what we're seeing in I bonds.

IF IT SOUNDS TOO GOOD ...

The old adage, "If it sounds too good to be true, it probably is" applies. There is truth to some of the hype about investing in bonds in an inflationary environment, but the devil is in the details. While I bonds appear attractive today, they are less desirable given their limitations, and TIPS are not producing hoped-for returns.

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