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WEALTH MANAGEMENT

I Bonds Can Help Protect Your Savings Against Inflation.

With inflation reaching levels not seen in over forty years, investors are seeking protection. Series I Savings Bonds could be part of the solution.

Author: Robert Carnegie, CFA®, CFP®, Senior Wealth Advisor

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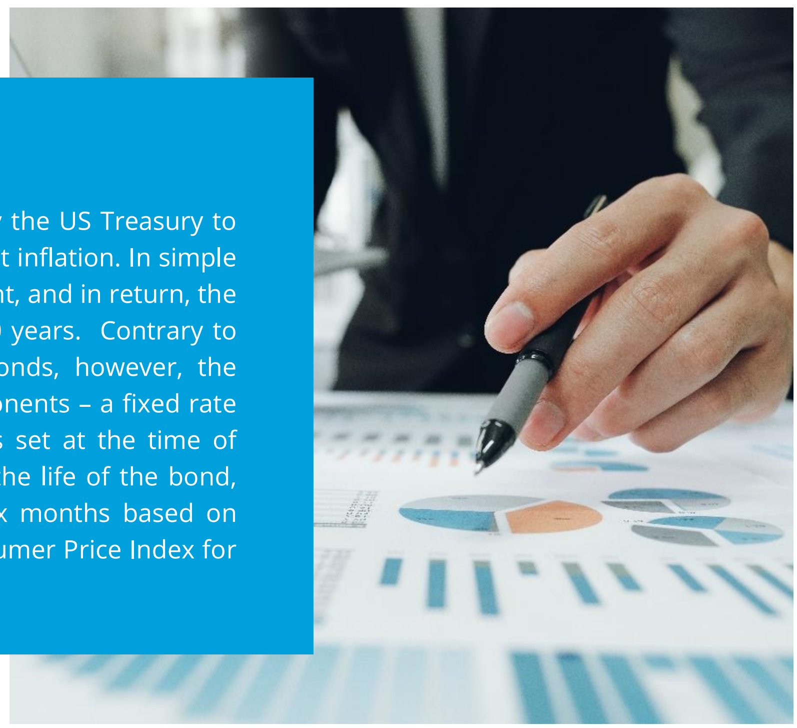
Introduction

While inflation was expected by many to be transitory, it has instead remained stubbornly persistent, reaching levels not seen since the early 1980s. Unfortunately, finding low-risk investments that also protect against inflation can be challenging. *Stocks and real estate* typically serve well as inflation hedges, but neither classifies as low-risk. *Commodities* can even front-run inflation, but prices for oil, lumber, wheat, etc. are volatile. *Gold* has an imperfect record versus inflation, is often volatile, and pays no yield. *Bonds* are associated with various forms of risk (interest rate, credit, and market) and can perform poorly as interest rates rise, including TIPS (Treasury Inflation-Protected Securities).

There is no single, perfect solution. The most prudent strategy to protect your balance sheet against the adverse effects of inflation is likely to be a diversified approach customized for your personal goals and objectives. That said, there is one “risk-free” option available today that offers direct inflation protection, albeit with some unique rules and limitations. Enter the Series I Savings Bond…

What are I Bonds?

I bonds are debt instruments issued by the US Treasury to help people protect their savings against inflation. In simple terms, you loan funds to the government, and in return, the Treasury pays you interest for up to 30 years. Contrary to fixed rate obligations like Treasury bonds, however, the interest rate on I bonds has two components – a fixed rate AND a variable rate. The fixed rate is set at the time of purchase and remains unchanged for the life of the bond, while the variable rate resets every six months based on inflation (non-seasonally adjusted Consumer Price Index for All Urban Consumers).



Are I Bonds Really Paying 7.12%?

Yes…for now. Currently, **the fixed rate on a newly issued I bond is 0%, and thus, the entire 7.12% is attributable to the variable, inflation-based component**, which is the highest on record since the I bond’s introduction in 1998. While enticing, investors should understand the following about I bond interest rates:

1. Since 2008, the fixed rate has never broken above 1% and, for much of that time, remained at or near 0%. Positive fixed rates seem poised for a comeback if the Fed continues down the path of higher interest rates, but that would only impact future purchasers. **If you buy an I bond today, you lock in a 0% fixed rate for the life of the bond.**

2. With a 0% fixed rate, the **only *guaranteed* return becomes the interest accrued during the first six months at the initial 7.12% variable rate**. Six months post-purchase, the rate will adjust, positively or negatively, and the new rate will apply for the next six months (and so on).
3. Any **returns beyond the first six months will be driven solely by future inflation, and 7.12% can be deceiving as it's an annual rate.** Receiving 7.12% for only half the year would equate to a 3.56% return over 12 months. Not as eye-catching, but still attractive.

The Catch

Each person can only acquire up to $10,000 of *electronic* I bonds per calendar year via www.treasurydirect.gov. Importantly, the annual cap applies to the owner/recipient, not the purchaser. Accordingly, after purchasing $10k for yourself, you could also purchase up to $10k for a spouse, child, friend, etc. Furthermore, note that if someone purchased $10k worth of I bonds on your behalf, those funds would be included in your individual $10k cap.

Are there any ways to purchase more than $10k worth of I bonds? Yes, there are two ways.

1. Use a Federal tax refund to buy up to $5k in *paper* I bonds. To do so, file Form 8888 with your return.
2. Utilize trusts or businesses to purchase up to $10k per entity. For example, a married couple with a joint trust can purchase $10k/person and $10k for the trust, totaling $30k in I bonds.

Other Key Rules & Regulations

- I bond rates cannot be negative. Even if deflation occurs, the lowest interest rate possible is 0%.
- You must own an I bond for at least 12 months before redemption is permitted.
- If you redeem within the first 5 years, you must repay the prior three months of interest.
- Interest compounds semiannually, meaning interest earned is added to the bond's principal value for the calculation of the next interest payment, a rather powerful attribute over time.

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Tax Treatment

I bond interest is exempt from state and local tax, but federal tax still applies unless funds are used for higher education and various requirements (i.e. income limitations) are met. The owner/recipient of the bond is responsible for the tax and can either pay annually or defer until redemption/maturity. Be advised that I bonds must be purchased with after-tax dollars and not within an IRA or Roth IRA.

Who Should Invest?

Compared to currently available interest rates on savings accounts, money markets, and short-term CDs, I bonds are a clear upgrade. Hence, **if you are holding idle cash you will not need in the next 12 months, you could consider an allocation to I bonds**. Furthermore, for those desiring more inflation protection in their portfolios, I bonds, even at a small allocation, certainly have value.

Short Term Wins

If you are holding excess cash in the bank that is earning next to nothing, you may be concerned that inflation is eating away the purchasing power of those funds. Instead, imagine that you were to purchase $10,000 of I bonds with the intention of redeeming as soon as possible after one year. You would accrue $356 in interest for the first six months (half of 7.12%). Assuming the worst-case and unrealistic scenario of the variable rate resetting to zero on May 1st, you would receive nothing additional for the next six months. The Treasury cannot ask you to repay $0 in interest received during the three months prior to redemption, and thus the outcome for year one would be $356 or 3.56% with plenty of upside given inflation remains elevated. Most importantly, the funds kept pace with inflation and maintained purchasing power.

Long Term Scenarios

Moving beyond year one, the expected return becomes a mystery with a 0% fixed rate. Inflationary trends will guide the outcome, and while recently there seem to be limitless prognostications calling for either perpetual hyperinflation or deflation, the most probable outcome likely lies somewhere in between. Inflation averaged roughly 2-2.5% over the past 30 years, and if longer-term history can be relied upon as a guide, one could reasonably expect to accrue at least some interest in most years and 100% of the invested principal upon redemption.

Additionally, another viable comparison is an I bond vs. cheap debt. For example, if you are planning to make a $10,000 principal payment on a low-interest, 2.0% car loan this year, why not instead invest $10,000 in I bonds, pocket an extra $156 ($356 - $200), at minimum, and make the payment next year? Depending on future inflation, it may even be wise to continue kicking that can further down the road.

Timing

To **lock in 7.12% for the first six months, you must make a purchase before May 1st** when the Treasury will announce the new fixed (if there is one) and variable rates. Ideally, complete the purchase with a few days to spare, as it does take time for processing. Since inflation remains elevated, an April purchase could put you in a position to lock in a relatively equivalent or better rate for the entire first year.