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FINANCIAL ADVISORS

Should You Buy Series I Savings Bonds?

By Mark Haser, MBA, CFP

Series I bonds are one type of ***inflation-protected government bond*** offered by the Treasury department. Inflation has been persistently low in recent years, which has led most people to ignore I bonds…until now.

How Do I Bonds Work?

I bonds pay an interest rate that is based on the prevailing level of inflation and is a combination of a fixed rate and a variable rate. The Treasury department announces the new fixed rate for I bonds every six months (in May and November). As of this writing, ***I bonds are paying 9.62% for the inflation rate and 0% for the fixed rate***, on an annualized basis.

The fixed rate applies to the I bond for the life of the bond. The inflation (variable) rate on the bond can change every six months based on the Consumer Price Index (CPI), including food and energy. The combination of these two rates (based on a formula) determines the actual rate of interest. Importantly, even in periods of deflation ***the combined rate can never be negative***.

I bonds earn interest for 30 years (unless you cash them in before then). They are illiquid for the first year, meaning you cannot redeem them. If you cash them in before five years, you lose the final three months of interest. After five years, the bonds are fully liquid with no penalty. I bonds earn interest every month and compound twice a year, meaning the interest from the prior six months is added to the bond's principal value that you receive when you cash them out.

The interest you earn on your I bond is subject to federal income tax, but not to state or local income tax. You can pay the tax each year as the interest accrues, or you can defer reporting the interest and paying the tax until you cash in the bond. Most people prefer the latter since ***Series I bonds do not provide any current cash flow*** with which to pay the tax bill.

Limitations on Purchasing I Bonds

As an investor, you are limited to a ***maximum purchase of $10,000 of I bonds each calendar year.*** If you receive a gift of I bonds from someone else, this will count towards your allotment of $10,000. You can eke out an extra $5,000 per year if you use your federal tax refund to directly purchase the extra amount, but this assumes you have a refund.

As mentioned earlier, Series I bonds do not provide a coupon payment, so they are not a great form of cash flow. That said, you could create your own "bond ladder" by making regular annual purchases and, eventually, redemptions.

Should You Purchase I Bonds (as a Gift) for Your Kids?

As a parent, you may want to purchase I bonds for your kids as a means of saving for college. The ***government allows you to exclude I bond interest from federal income tax when you use the I bond to pay for qualifying higher education expenses***.

Alternatively, you may simply want to give the I bonds to your children as a gift. If you want to buy I bonds for your child, you can do so through treasurydirect.gov using what is called a "Minor Linked Account." When your child reaches the age of majority, just be aware that it is now their money to use however they like.

Who Should Consider Purchasing I Bonds?

Given the purchase limit of $10,000 per person per year, I bonds do not move the needle much for high-net-worth investors. Another problem for investors in a high-income bracket is that the IRS disallows the exclusion of income tax for higher education expenses when your adjusted gross income exceeds $98,200 for single filers and $154,800 for joint filers.

However, for investors of more modest means, I bonds can play a valuable role in a portfolio. Simply put, ***I bonds are a low-risk financial instrument*** (remember, they are backed by the US government and the rate they pay can never be negative even in a deflationary environment, such as we had briefly in 2009 and 2015) that can help protect your savings from inflation. They can be a nice complement to saving in a 529 plan for your child's education, providing a tax-free return if you are under the income threshold.

If you are interested in I bonds for the long run, consider the following example:

If a married couple had purchased the maximum of $20,000 of I bonds ($10,000 per person) every year for the last 24 years (beginning in 1998), they would have invested $480,000 into I bonds over that period (the $10K per year cap used to be higher, but let us assume it wasn't). This portfolio of I bonds would be worth $887K today. The initial tranche of I bonds purchased in 1998 would be worth $82K after this latest period of semiannual compounding (a return of 6% annualized). Our married couple has six more years over which this tranche can continue to earn interest (30 years total), after which point they must cash it out and pay the federal income tax.

In case you are curious, over the past 24 years, the highest returning I bonds were from 2000 (6.3% annualized) and the lowest returning were from the period 2008 – 2013 (all have earned about 2.5% annualized…thus far).

The Bottom Line

The inflation-based variable rate of I bonds makes them unique in the land of financial instruments. Due to the purchase limitations, they are much ***more impactful for investors of modest means***, but they are worthy of consideration as a long-term investment particularly for anyone who is losing sleep at night over the prospect of sustained high inflation.

To purchase Series I bonds, you must use treasurydirect.gov as they do not trade on the secondary market.

Artemis Financial Advisors
115 Newbury Street
Suite 302
Boston, MA 02116