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summaries

SIGMA INVESTMENT COUNSELORS

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UNDERSTANDING THE SERIES I SAVINGS BONDS

Given the current stock and fixed income market environment, a guaranteed 9.62% return on your money can raise some eyebrows. Well, that is the current composite interest rate for Series I Savings Bonds issued by the United State Treasury for those purchasing prior to October of this year. The bonds appealing interest rate has been covered by major U.S. media outlets and is also responsible for instigating this letter today. Clients have recently been asking us what the nuances are and if this is something that they should consider adding to their investment portfolio.

What is the Rate of Return on the I Bond?

The rate of return on the I Bond will vary over time. In fact, the bond's interest rate gets reset every six months, based on a variable interest rate and a fixed interest rate. The variable rate is adjusted semi-annually, in May and November, and is closely tied to the Consumer Price Index which is how inflation is measured. At the time of this writing, the variable rate is 4.81% for a six-month holding period. The fixed rate is set for the life of the bond at the time of purchase. At this time, that rate is 0.00%. Therefore, if an investor buys an I bond today, the interest earned includes a 4.81% variable rate and a 0.00% base rate, resulting in a composite return of 4.81% for the next six months, or 9.62% on an annualized basis. Following the initial six month holding period, the base rate will stay the same but the variable rate will be adjusted higher or lower based on the direction of future inflation rates.

It is important to note that the variable rate of the bond is not paid out as interest income. Instead, the par value of the bond will increase by the dollar amount of the variable rate. To illustrate this point, assume that an investor buys a $10,000 I bond and intends to hold it for five years. This implies that the variable rate will be recalibrated on ten occasions. For simplicity, let's assume that the CPI index starts at 4.75% for the first six month period and falls by 0.25% for each period following. In this scenario, the variable rate would be 4.75% for the first six months, 4.5% for the next six months, 4.25% for the third six month period, and so on. The final sixth month variable rate would be 2.50%. The cumulative impact of the par value increasing in this fashion would result in a par value at the time of maturity of $14,274.

In a highly inflationary environment such as the one we now are experiencing, investors may find such an investment an appealing addition to one's portfolio.

How does one go about purchasing one?

The paper bonds are only available to purchase with your tax refund and are then delivered by mail. One must complete IRS Form 8888 when filing their taxes and follow the instructions requested.

The electronic bonds can only be purchased on www.treasurydirect.gov where one could then create an account and begin the process of filling in the information requested.

The minimum purchase for one of these bonds begins at $25 when purchased electronically, and $50 when purchasing a paper copy. The denominations range from $50, $100, $200, $500, and $1,000 for paper bonds and any amount above $25, to the penny, when purchased electronically. It is important to keep in mind the maximum purchase an individual can make each calendar year is $10,000 (electronic bond) and $5,000 (paper bond).

These bonds are non-marketable securities, which means they must be purchased in one of the two ways listed above. As a result, we (Sigma) cannot purchase these bonds for our clients' accounts. Yet, we are happy to discuss if such an investment makes sense in one's plan. It may also prove to be valuable for our clients' children and grandchildren, perhaps as a birthday or holiday gift.

Cashing in?

The bonds are issued with a 30-year maturity date and are required to be held for a minimum of 12 months. If one were to cash in before 5 years, then the last three months of interest are forfeited as a penalty.

What about taxes?

I Bonds can be taxed under two different methods – cash and accrual. Under the cash method investors must pay taxes on any interest when the bond is sold. When using the accrual method, the taxes on imputed interest are applied every year. In most instances, the bonds are taxed only at the federal level. However, when the bond is sold by a tax payer who meets certain income requirements and uses the proceeds for qualified higher education expenses there is no longer a tax liability.

In Summary

At Sigma, we take the time to understand each of our client's unique needs. In certain circumstances, particularly where a client is sitting on excess liquidity with no designated obligations for that money on the horizon, the I Bond solution could prove to be a nice placeholder.

All comments & suggestions are welcomed.

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