I Bonds -- Look Before You Leap

With low risk and an attractive yield, I bonds are a hot commodity these days. But they come with terms and restrictions that may make them unsuitable for many.

I bonds were recently paying nearly 10% interest, their highest rate since they were created in 1998.*

For investors seeking safety and yield, or those wary of today's volatile stock market, inflation-adjusted bonds -- aka, I bonds -- seem to be the perfect solution.[1] As of November 30, they were paying 6.89% interest, and were paying as high as 9.62% a month earlier -- their highest rate since they were created in 1998.* They are issued by the U.S. Treasury and are backed by the full faith and credit of the United States government. And, like other Treasury securities, I bond interest is exempt from state and local income taxes.[2]

So what's not to like? As with any investment, I bonds have terms and conditions. Perhaps most important is their yield, which is calculated and reset twice a year (May and November). It is based on a formula that combines a fixed rate (currently 0.40%) and an inflation rate -- the Consumer Price Index for All Urban Consumers, or CPI-U. That formula currently produces an attractive yield because inflation is high. If inflation abates, so will the yield.

The possibility of a drop in yield would seem acceptable to most investors, provided they could just cash in their bonds if/when inflation falls. But with I bonds, it's not that simple. You must hold the bond for a minimum of one year, and if you cash in anytime between one and five years, you will lose three months of interest. So I bonds work best when inflation is high -- and is expected to stay high.

Other Factors to Consider

In addition to yield and holding period restrictions, there are several other caveats to bear in mind.

I bonds are issued in denominations as low as $25 and carry a 30-year maturity. They must be bought directly from the Treasury, either through your tax refund (on Form 8888) or through TreasuryDirect. There is no secondary market. If and when you cash in, you must go through TreasuryDirect.

You can buy up to $5,000 in paper I bonds per year through your tax refund and up to $10,000 in electronic I bonds through TreasuryDirect, for a combined annual limit of $15,000. For higher-net-worth investors looking to invest hundreds of thousands at a time, these limits may be too low to bother with.

I bonds earn interest monthly, and interest is compounded semiannually. Taxwise, you can opt to report each year's earnings or wait to report all the earnings when you cash in the bond. But interest is not actually paid until you cash in the bond or it matures. So I bonds would be a poor choice if you were seeking an income stream throughout the life of the bond.

Pros

- Yields are currently high
- Good inflation protection
- Very low risk -- principal is guaranteed
- Interest is not subject to state and local income taxes[2]

Cons

- $15,000 per year limit (combined paper and electronic)
- Must hold a minimum of one year
- Three-month interest penalty applies if you cash out before five years
- Rate changes twice a year
- Can only buy and redeem bonds through the Treasury

When all is considered, I bonds make the most sense for smaller investors who do not need to touch the money for at least one year. Right now, they offer a good alternative to a low-yielding savings account or bank CD. They also work best in an inflationary environment, where inflation is expected to remain high. And since I bond interest is not subject to state and local income taxes, those in high-tax states and cities will see an added benefit -- even more so if the funds are used for qualified higher education expenses when cashed in.

Talk to a financial professional to see if I bonds might work for you.

*TreasuryDirect.

[1]Note that I Bonds are not the same as Treasury Inflation-Protected Securities (TIPS).

[2]Interest may also be exempt from federal income tax if used to fund qualified higher education expenses and other criteria are met.