Retirement Income
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Buy ‘I Bonds’ and Worry Less about Inflation

By No Author *Thu, Sep 23, 2021*

Four inflation mavens--Zvi Bodie, Mel Lindauer, David Enna and Michael Ashton--urge inflation-sensitive investors to embrace the government's 'I Bonds.' They sent this 'I Bond Manifesto' to the Consumer Financial Protection Bureau.

Financial planners and investment advisors all tell you to create an emergency fund before you start investing in risky assets. Your emergency fund should be held in safe and liquid assets like FDIC-insured saving accounts.

But interest rates on these accounts are close to zero and taxable. Moreover, if these accounts are retirement accounts such as an IRA, withdrawals before age 59½ are subject to a 10% penalty in addition to taxes on the withdrawals.

So where should people invest their emergency funds? We say they should consider U.S. Treasury Series I Saving Bonds, commonly called I Bonds, which are distinct from Treasury Inflation-Protected Securities, or TIPS. (For a side-by-side comparison of the two, click **here**.)

What are I Bonds?

First introduced in September 1998 I Bonds (the “I” stand for “Inflation”) are inflation-protected, are issued by the United States Treasury, and provide a guaranteed real rate of return for 30 years. This is in contrast to the nominal fixed rate of interest provided by most traditional bonds and CDs.

The total yield of an I Bond is made up of two components: a fixed rate that remains the same for the 30-year life of the bond, and an inflation adjustment that’s reset every six months. The fixed rate is currently zero, and the last inflation adjustment in May 2021 was 3.54% per year.

You add these two components together to arrive at the composite rate of 3.54% per year.

I Bonds were designed primarily for small savers/investors. You can buy a maximum of $10,000 of I Bonds a year for each Social Security number via TreasuryDirect (treasurydirect.gov).

In addition you can buy them with any federal tax refund due to you, up to $5,000, for which you will receive paper I Bonds. You cannot hold them in a special retirement account, but the taxes due are deferred until maturity or the date they are redeemed. If you redeem I Bonds prior to five years, you’ll lose the last three months’ interest. After holding them for five years, there is no penalty for redeeming I Bonds before maturity, except that the federal tax on the interest must be paid in the same year as the redemption.

I Bonds offer many benefits:

- **They’re risk-free.** They are obligations of the U.S. Treasury, so they are even more secure than Social Security benefits. (It is possible for the U.S. Treasury to default on these bonds, so strictly speaking they are not completely free of default risk as explained above.)
- **They offer inflation protection.** That’s especially important for retirees who no longer have wage increases to rely upon. With all the current government spending and deficits, inflation could return with a vengeance. I Bonds protect you against the ravages of future inflation.
- **They’re tax-deferred.** Even though you purchase I Bonds with after-tax money for your taxable account, they offer tax deferral for up to 30 years. You can elect to report the interest annually if you prefer, but most investors choose the default tax deferral option and thus only pay tax on the accumulated interest when they eventually redeem the I Bonds.
- **They’re flexible.** They offer a tax timing option. They can be redeemed any time between one and 30 years. That offers lots of flexibility after owning them for one year. This flexibility allows you to buy I Bonds when you’re in a high tax bracket and redeem them when you’re in a lower tax bracket, such as after you’ve retired or are temporarily out of work.
- **They’re free from state and local taxation.** This can mean higher after-tax returns for those investors who live in high-tax states, and they’re even better yet for folks who live in areas where they pay both state and local taxes.
- **If used for qualifying educational expenses, the interest earned is free from federal taxes.**
- **They offer a put option.** If future I Bonds offer a more attractive fixed rate, it may make economic sense to redeem the older lower-yielding I Bonds, pay the taxes due on the interest earned, and then buy the newer I Bonds with the higher fixed rate. (Remember, however, if you redeem I Bonds within the five years of purchase, you will forfeit the last three months of interest.)
- **You can’t lose money.** The composite rate can never go below 0%. I Bonds will never return less in nominal terms than you invested in them even if the country enters a prolonged period of deflation. You never lose the interest you’ve earned. In real terms

> you do better if there is deflation than if there is inflation. A recent bout of reported deflation took the I Bond composite yield to 0% for a six-month period. But as a result of the 0% “floor,” holders actually outstripped inflation by more than the guaranteed fixed rate during that period. So, if your I bond was worth $10,000 before that period of deflation, it would have been worth $10,000 after the deflation adjustment period ended. However, because of deflation, that $10,000 would buy more goods and services.

How I Bonds work

Now let’s explore the mechanics of purchasing and redeeming I Bonds and talk a bit about how they work. You must first open an individual account at TreasuryDirect.gov and link it to your bank account. Once your account is open, you can then make your purchases online and the Treasury will deduct the purchase price from your linked bank account.

Purchase limits. There is an annual purchase limit of $10,000 in I Bonds in electronic form per Social Security number. A married couple could, therefore, purchase a total of $20,000 per year.

A tax-time purchase option. The option to use your tax refund to buy up to $5,000 in paper I Bonds raises your limit from $10,000 to $15.000 in that year–$10,000 in electronic form and $5,000 in paper form.

Timing your purchases. Interest is earned on the last day of each month and is posted to your account on the first day of the following month. So, if you own your I Bonds on the last day of any month, you’ll earn that full month’s interest. Therefore, it’s best to buy your I Bonds near the end of the month, since you can earn a full month’s interest while only owning the I Bonds for perhaps a day or two. On the other hand, when redeeming I Bonds, you’ll want to do so on or near the first business day of the month, since redeeming them later in the month won’t earn you any additional interest.

Redeeming paper I Bonds. Simply take your paper I Bonds to your bank, sign the back and the bank will credit your account just as if you had deposited cash. The funds will normally be available to you the following day. You could also receive cash.

Redeeming electronic I Bonds. You can redeem your I Bonds (or any portion of your bond holdings, so long as you leave at least $25 in your account) using your online account. The money is then transferred into your linked bank account.

Avoiding probate. I Bonds don’t qualify for a step-up in cost basis at one’s death as many other investments, such as stocks and real estate, do. (I Bonds are like bank-CDs in that regard.) But you can title them in such a way as to avoid having them included in your estate subject to probate—by having either a second co-owner or a beneficiary listed on your I Bonds.

Zvi Bodie is emeritus professor of economics at Boston University, Mel Lindauer wrote The Bogleheads’ Guide to Retirement Planning*, David Enna is founder of Tipswatch.com, and Michael Ashton is ‘The Inflation Guy’ at Enduringinvestments.com.*