Fighting Inflation with I Bonds

As inflation continues to eat away at consumers' savings and purchasing power, investors are searching for new ways to insulate their assets while also earning a reliable return in a volatile market. Enter the Series I Savings Bond, a virtually risk-free investment that promises a 9.62% return through October 2022.

Series I Savings Bonds, also known as 'I bonds,' have become increasingly more popular in recent months, as they are specifically designed to be a hedge against inflation. Here is what you need to know about I bonds in order to determine whether or not they're a worthwhile investment for you.

Inflation is slowly eroding your savings

If there's one thing we know about periods of high inflation, it's that money loses value over time. Simply stated, a dollar today is going to be worth more than that same dollar tomorrow. With inflation levels climbing above 8%, investors who leave their money in traditional savings accounts (which tend to earn close to 0% interest) will see their funds gradually diluted.

In order to protect the value of your savings from inflation, you'll need to earn returns that are in excess of the inflation rate. Luckily, today's inflation rates are being outpaced by I bond interest rates, which presents investors with a unique opportunity.

I bonds can protect you from inflation

Like treasuries, I bonds are backed by the full faith and credit of the U.S. government and therefore carry a next-to-zero probability of default. But, while other low-risk investments offer similarly low yields, I bonds are currently serving up a whopping 9.62% return for discerning investors.

I bond yields are calculated by combining two interest rates: a fixed rate that's established by the U.S. Treasury and a variable rate that scales with inflation. Although the Treasury has the option to adjust the fixed rate every six months, I bonds maintain the fixed rate that they were issued under for their full maturity of up to 30 years. The fixed rate for I bonds remains at 0% for the third consecutive year.

The variable interest rate is adjusted every six months to reflect current levels of inflation. In May and November of each year, the Treasury uses the Consumer Price Index (CPI) to set a new variable rate. A higher CPI reflects higher levels of inflation, and results in the Treasury assigning a higher variable interest rate. Unlike the fixed rate–which is guaranteed over the lifetime of the bond–the variable rate is only guaranteed for six months following the bond's issuance. Today's variable rate (quoted semi-annually) is 4.81%.

When taken together, these two rates result in a combined interest rate of 9.62% from now until November. That's 9.62% of risk-free profit that you can lock in over the next several months.

A couple things to consider before investing

Investing in I bonds will not be for everyone–doing so comes with a couple important caveats that could bear significant implications for your finances; particularly, in the short-term.

Annual limits

Generally, the Federal Reserve only allows individuals to buy up to $10,000 worth of I Bonds each calendar year. These bonds are available for purchase through the Treasury Direct website. There are, however, exceptions to this rule. For those interested in stashing away more funds than the annual limit allows, there are a handful of strategies that are available.

First, if you still haven't gotten around to filing your tax return for this past year, you can elect to receive $5,000 of your refund in paper I bonds. This effectively bumps the amount of I Bonds you can buy from $10,000 to $15,000 per year, assuming you had the prescience to submit an IRS Form 8888 with your tax return.

Second, the $10,000 annual limit (or $15,000 limit, if you take advantage of the tax refund option) applies to *each individual*, meaning that every member of your household can purchase this amount of I bonds. Families with children can purchase I bonds on behalf of each child, but these investments must be made in custodial accounts and are treated as gifts for tax purposes.

Finally, if you own a business or a living trust, you can purchase I bonds on behalf of those entities. Whether you're self-employed, own a family LLC, or make investment decisions for a corporation, you can purchase $10,000 of I bonds for your business. The same goes for living trusts–as long as they're considered separate entities come tax time, you can buy I bonds for multiple trusts if you want to. Similarly to with children, the I bonds you buy for your business or trust must be held in separate accounts.

To illustrate how maximizing your I bond holdings can look in practice, consider the following example. A married couple, each with their own business and living trust, would be able to purchase up to $60,000 in I bonds, or $70,000 if they opt for additional paper bonds as part of their tax refund. If they have a child, then they're allowed to buy another $10,000 in I bonds per year on their behalf. Although these bonds would live in a few different accounts, that's a total of $80,000 in inflation-protected securities.

Illiquidity

I bonds are intended to be investments that are held over a relatively-longer period of time. Once you purchase an I bond, you must hold it for at least twelve months before you even have the option to redeem it. What's more, if you cash in your bonds before you've held them for five years, you must surrender the last three months of interest payments. For example, if you hold an I bond for 18 months before redeeming it, then you'll only receive the first 15 months of interest.

These holding requirements bear important implications for investors. To start, your investment will be locked-up for at least a year, which means that you won't be able to access your funds should an unexpected cash need arise. Further, since your earnings are diminished if you cash in your bonds early, investors are more inclined to abide by the requisite five-year holding period. This illiquidity could present challenges for some, potentially forcing them to look elsewhere for inflation protection.

Be sure to factor in the above considerations when deciding whether or not it makes sense for you to put your money into I bonds.

Best,

Robert (Rory) J. O'Hara III, CFP®, CRPC®
Founder I Senior Managing Partner