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Savings bonds: Should you buy now or later?

You might get a better deal if you buy before rate changes Nov. 1 — or not

By Sandra Block
USA TODAY

The consumer price index rose 1.2% in September, the largest monthly increase in 25 years. Economists hastened to point out that the "core" rate, which excludes food and energy prices, rose only 0.1%. That's comforting if you bike to work and grow your own food. Otherwise, you're probably worried about inflation.

For savers, though, there's an upside to inflation. On Nov.1, the rate on inflation-adjusted Savings Bonds could rise as high as 6.9%.

But because of the way I Bonds are constructed, investors may be better off buying before the new rate is announced, says Daniel Pederson, author of Savings Bonds: When To Hold, When To Fold and Everything In-Between.

The rate on I Bonds consists of two parts: an inflation component that's adjusted every six months and a fixed rate that stays the same for the life of the bond. On May1, Treasury raised the fixed rate to 1.2% from 1%. Come Nov.1, Treasury could raise it again, lower it or leave it alone.

Pederson believes Treasury may lower the fixed rate to as low as 0.5%. Because of the high inflation rate, Treasury can cut the fixed rate significantly "and still have a really attractive composite rate," he says.

For that reason, Pederson recommends buying I Bonds before Nov.1. If you take his advice, you'll earn the current rate of 4.8% for the next six months. After that, your I Bond will adjust to about 6.9%, and you'll earn that rate for the next six months.

Over the long term, a cut in the fixed rate would make your I Bonds less attractive. If Treasury cuts the fixed rate to 0.5%, the combined rate for I Bonds purchased after Nov.1 will be about 6.2% — not a bad return. But over the life of your I Bond, you'll earn only half a percentage point over the inflation rate, vs. a 1.2% inflation premium on an I Bond purchased before Nov.1, Pederson says.

If you want to lock in the current fixed rate, make sure your I Bonds have an October issue date. Don't wait until the last minute. Investors who buy their Savings Bonds electronically through Treasury Direct need to provide at least 24 hours for the money to be withdrawn from their accounts, says Stephen Meyerhardt, spokesman for Treasury's Bureau of Public Debt. He recommends placing orders no later than Friday to ensure an October issue date.

Investors who buy their Savings Bonds through a bank branch can get an October issue date on I Bonds purchased as late as Oct.31, Meyerhardt says.

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But that's risky: If you buy after normal business hours, you may end up with a November issue date. To be safe, buy your I Bonds no later than Thursday, Pederson says.

No need to rush?

Tom Adams, author of Savings Bond Alert, has a different fixed-rate forecast. He says there's a good chance Treasury will raise the fixed rate for I Bonds. If he's right, the combined rate for I Bonds will top 7%, and investors who buy after Oct.31 will get a better deal.

Adams believes the fixed rate for I Bonds is linked to the equivalent market rate for Treasury Inflation-Protected Securities, or TIPS. TIPS are inflation-adjusted bonds issued by the U.S. Treasury, and the market rate on those securities is higher than it was six months ago, Adams says. His prediction: Treasury will raise the fixed rate on I Bonds to 1.3% to 1.5%.

Treasury officials won't reveal how the fixed rate is determined. The rate is "discretionary on the part of the Treasury," Meyerhardt says.

Playing the odds

Whether you buy I Bonds before Nov. 1 or after, you'll get a rate that beats other conservative investments, such as certificates of deposit and money market funds.

When you buy Savings Bonds, you're required to hold them for a minimum of 12 months, so don't buy one if you think you'll need the money before then. If you cash them in before you've held them five years, you'll forfeit three months of interest.

But at current rates, investors who sell I Bonds after a year and take the penalty will still earn more than they can get on most other low-risk investments, Pederson says.

Treasury will also announce a new rate for EE Bonds on Nov.1, but a recent change in the way the rate for those bonds is calculated has made them less attractive, analysts say.

Earlier this year, Treasury switched EE Savings Bonds to a fixed-rate formula. The rate is adjusted every six months, but the rate in effect when you buy EE bonds will remain the same for as long as you own them.

EE Bonds issued from May1 through Oct.31 pay a 3.5% rate, and Pederson predicts the rate will stay the same on Nov.1.

For more information, go to www.treasurydirect.gov.

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Savings bonds: Should you buy now or later?

Objectives:

Students will:

- read and discuss the USA TODAY article, "Savings bonds: Should you buy now or later?"
- complete a graphic organizer that requires them to synthesize information related to bonds and inflation.
- create a new way of presenting information about I-Bonds.

Concepts:

- investing
- inflation
- Consumer Price Index
- bonds

Procedure:

Teach a couple of mini-lessons on the Consumer Price Index, inflation and bonds to provide students with the background needed to understand the financial concepts presented in the article. Distribute the attached activity sheets to facilitate note taking and discussions. (Note: The mini-lessons can be taught as webquests. Use the worksheets as prompts for information gathering.) The culminating activity will ask students to re-interpret the main points of the article.

Preparation:

1. Read the USA TODAY article, "Savings bonds: Should you buy now or later?" Add to the pre-reading and discussion questions as necessary to meet the needs of your students.

2. Distribute copies of the mini-lesson worksheets to students.

Activity at a glance:

- Grade level: 9-12
- Subjects: economics, personal finance, comparison, comprehension
- Estimated time for this activity: 90 minutes, plus homework

Materials:

- Reading: "Savings bonds: Should you buy now or later?"
- Chart paper
- Overhead projector
- Internet access (or teacher can provide information about local income and property taxes to students)
- Calculators

Pre-reading and discussion

Consumer Price Index, inflation and bonds

Consumer Price Index (CPI): A statistical measure of the average prices of specific goods and services purchased by working people in urban areas. This measure is used to track the increase or decrease in the cost of everyday expenses and items (including taxes, rent, electricity, etc.) for consumption by urban households.

Inflation: The increase in the prices of a selected statistical measure, like the CPI.

Q. How does the CPI affect individuals?
A. As inflation increases, the cost of living (rent, prices, etc.) increases. Therefore, inflation rates have a direct effect on people and their pocketbooks.

For example, imagine that the current inflation rate is 2%. You have been saving to buy a new radio that cost $100 last year. A year later, because of inflation, the radio costs $102.

Now, imagine that you want to buy a fully loaded luxury vehicle that costs $50,000. If inflation continues at the same rate, how much will the same car cost in five years?

Q. When does inflation become a problem?
A. Generally, it doesn't — as long as your income rises with inflation. Problems arise when a person's salary increases or payroll deductions (for health care, etc.) are not consistent with or above the rate of inflation. As a result, individuals' dollars are stretched thinner.

Bonds: Interest-bearing certificates sold by governments or corporations who guarantee payment of the original investment plus interest by a specified future date. They are long-term loan certificates used to raise capital. Bonds pay either fixed or floating interest. Put simply, a bond is an IOU.

Additional resources:

- Treasury Direct provides information on individual, personal, corporate and government investing. For more information, visit www.savingsbonds.gov.
- The Bureau of Public Debt provides easy-to-understand information for students who want to learn more about investing in savings bonds. Check out www.publicdebt.treas.gov/sav/savkids.htm for more details.

Activity extensions:

- Write an informative article on how to select and invest in bonds. What should you look for? What are some risks?
- Graph an I-Bond's payouts for the last 10 years.
- Research local bonds. Is your local government offering bonds? Why or why not?
- Compare the difference between investing in the stock market and investing in bonds. Which has a higher growth potential? Which has more risk?
- Interview a bond broker about her predictions for I Bonds.

Five types of bonds

Zero Coupon Bond: This type of bond does not pay out interest (coupons). Instead, the bond owner makes money by purchasing the bond at a greatly reduced price from its face value, which is the amount the bond will be worth when it "matures." When a zero coupon bond matures, the investor will receive one lump sum equal to the initial investment plus interest that has accrued.

Floating Rate Bond: The interest rate on this type of bond changes. Also, the issuer or the bond-holder can change the date of the bond's maturity.

Callable Bond: This bond lets the issuer (the company or government) pay off the balance of the bond before the bond reaches maturity.

Puttable Bond: The owner of the bond can force the company to buy the principal of the bond before it reaches maturity. The repurchase price is determined when the bond is issued.

Convertible Bond: The owner of the bond is able to exchange the bond for shares of the company's stock at a specific date.

How bonds are issued

Municipal Bonds: Issued by state and local governments, universities, colleges, hospitals, power companies, toll roads and public utilities. The money generated from the bonds allows the organizations to complete projects, such as building roads and schools. These bonds offer benefits that others do not, e.g., the interest is exempt from federal income tax and some state and local taxes, too.

Government Securities: U.S. government securities are divided into two categories: those that can be traded and those that cannot. The bonds that can be traded are called "marketable." Bonds that cannot be traded are "non-marketable."

Mortgage Bonds: Issued by private companies (including banks). Bond owners are paid at a set rate, regardless of company profit. A marketable bond.

Government Security Bonds: Bonds issued by the U.S. Treasury are assigned letter designations. These bonds are listed below.

I Bonds: Savings bonds designed to protect the investor from inflation. The interest rate is split in half – one half is set for the life of the bond, the other changes every six-months, based on inflation rates. I bonds are purchased for face value.

E Bonds (War Bonds): These bonds were issued between May 1941 and June 1980. They were given out at 75% of their face value. They pay a minimum 4% interest rate and are no longer issued.

EE Bonds: Purchased for half the face value. These bonds earn interest for 30 years from the date of purchase. A non-marketable bond.

HH Bonds (Current Income Bonds): No longer issued. The minimum cost for these bonds was $500. The holder receives interest payments every six months since the date of issue. HH Bonds are non-marketable, but they can be traded for EE Bonds and Savings Notes.

T-bonds (Treasury bonds): These are long-term bonds. Once issued, they mature in 10 to 30 years and pay interest semiannually. Because the full faith and credit of the federal government backs them, they are considered the safest of all investments.

Investing in Bonds

Bonds are one of the safer types of investments because even if the company (or issuer) is losing money, interest payments (coupons) still must be made. In the event that a company declares bankruptcy, bond holders are paid before stockholders.

Inflation and bonds

Because bonds pay their owners at a set rate, during times of inflation, bonds with low rates will be less valuable when interest rates rise above the rate of the coupon. For example, let's say you have a bond with a coupon of 3%. Based on the CPI and other factors, the Federal Reserve decides to raise interest rates to 4%. Your coupon will not change; it will remain at 3%.*

*Note: Fixed bond rates have been on the decline in recent years. The current rate (as of November 2005) is 1%, compared to a 3.6% rate in May 2000.

In-class activity

1. Review what students learned in the mini-lessons:
   - What is inflation?
   - How does the CPI impact inflation?
   - Define bond.
   - What is an I Bond?
   - Explain the role inflation has on I Bonds.

2. Ask students to re-read the article, "Savings bonds: Should you buy now or later?" As they read, have them complete the mini-lesson worksheets to reinforce their comprehension. Ask students to write down questions that arise as they read the article and to make notes on points that need clarification. (This can be assigned as homework).

3. Finally, hold an in-class discussion about difficult financial concepts mentioned in the article that students are still having trouble understanding. Whenever possible, let students answer each other's questions.

Extension activities

Individuals or groups should create a new way of communicating the content of the article in layman's terms. Some ideas include:

- Write an article for a magazine called "Bonds for Dummies."
- Create pamphlets on I Bonds and the recent increase in the CPI to be distributed at a local supermarket.
- Conduct a mock interview with a classmate that tests his or her knowledge of the information presented in the article.
- Adopt the role of a bond broker . Create an I Bond pitch that you think would appeal to recent high school graduates.
- Create graphs and charts to visually communicate key points and statistics made in the article.
- Hindsight is 20-20. Decide whose economic forecast from the article was more accurate — Tom Adams' or Daniel Pederson's. Why?

Activity Sheet: CPI and Bonds

1. What is inflation? ______

2. What is the Consumer Price Index (CPI)? ______

3. How does the CPI affect inflation? ______

4. How does inflation impact individuals? ______

5. What happens when a person's salary doesn't keep up with inflation? ______

6. If the rate of inflation is 4% and your rent is tied to annual inflation, what would your rent be in 10 years if you pay $800 a month now? ______

Activity Sheet: Bonds

What is a bond? ____

____

____

____

Five types of bonds	What is it?

Bonds based on issuer	Issuer

Treasury bonds	What it does or how it works.

Why invest in bonds? ____

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____

____

What impact does inflation have on I Bonds? ____

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