

BONDS FOR INFLATION-FEARERS

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The government is introducing a new type of savings bond, hoping to make these conservative investments sexy to stock-crazy investors.

The Treasury Department unveiled on Wednesday a new type of savings bonds armored to protect their modest returns from marauding inflation. But with the stock market continuing its bull run and money pouring into mutual funds, the question is whether investors have any room for such age-old savings vehicles as bonds.

After all, The Dow is up 157 percent over the past five years and the Vanguard S&P 500 index fund posted a cumulative return of 185 percent over the same time.

As for inflation, it isn't the number one investor fear right now. You have to look back to the late 1980s for an annual inflation rate above 4 percent.

And you have to go back to the late 1970s to see an inflation rate around 10 percent annually. Some are speculating that inflation will go even lower than the 1.7 percent increase in the CPI for the past 12 months.

Investment Experts Skeptical
Advisors are skeptical these new bonds – the first new type of savings bonds since 1980 – will attract heavy investor interest when six of the eight denominations go on sale in September.

While the popularity of savings bonds has stayed relatively constant over the past few years, inflows into equity mutual funds have soared. In the first quarter of this year, households held \$186.5 billion in savings bonds. In comparison, stock mutual funds had assets of \$2.8 trillion at the end of April, according to the Investment Company Institute.

Meanwhile, inflation-indexed Treasury securities have been available for more than a year in denominations starting at \$1,000. They've been relatively

unpopular in their primarily institutional market because of the low-inflation environment.

"In an environment where stocks have outperformed everything else in the past 15 years, they don't hold a lot of appeal," says James Demmert at Main Street Research, an investment advisory firm. But that doesn't mean investors should overlook them. "They're a very contrarian vehicle in today's environment, but they may end up being a very smart vehicle."

Indeed, the Treasury Department and Vice President Al Gore are pitching Series I Inflation-Indexed Savings Bonds as weapons against the unknown inflationary – or deflationary – future. The message is that investors should not be lulled into a false sense of purchasing-power security for their long-term investing strategy.

How I Bonds Work

These I Bonds are similar to popular Series EE saving bonds, as the same tax advantages apply. Earnings are exempt from state and local income taxes. Federal taxes can be deferred until the bond is cashed in or it reaches final maturity. And interest may be exempt from taxes if used for secondary education tuition. And they both have a 30-year maturity.

But the earnings picture is different.

"This is an even more conservative security than your normal savings bond," says James Kochan, director of fixed-income asset management at Robert W. Baird & Co. "With a regular savings bond, the yield is going to be fixed the day you buy the security. That may or may not be a good return depending upon a number of things, but primarily the rate of inflation."

The fixed earnings rate of regular savings bonds can be eroded in real dollar terms if inflation climbs. But the I

Bonds earnings rate is based on a combination of a fixed rate of return and a semiannual inflation rate.

Each May and November, the Treasury determines the fixed rate of return for bonds issued during that six-month period. At the same time, it calculates the inflation rate based on changes in the Consumer Price Index. That semiannual inflation rate is combined with the fixed rate to determine the I Bond's earnings rate for the next six months.

Keeping Ahead of Inflation

The advantage: If inflation starts to climb sometime down the road, your bonds will keep up and help preserve the value of your earnings. I Bonds are designed to give a guaranteed real rate of return – "real" because it's protected from inflation eroding its purchasing power.

There are disadvantages. "You start off with a lower yield and if inflation stays as low as it's been, you're going to earn less than you would in a traditional savings bond says Kochan. Right now, these bonds are for very cautious investors. "You're basically making a bet that the rate of inflation will increase over the life of the bond."

But if inflation kicks up again or stocks start to falter, these bonds will become a popular option.

"In a rocky environment, these bonds are a good investment," says Demmert. "The economy is maturing; at some point it will shake off the Asian problems and inflation is likely to become an issue. It's nice to see that vehicle available."



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