EE savings bonds: They're worth a peek

The floating rate and guaranteed minimum return rate provide several attractive reasons for considering these often-neglected bonds if you are a long-term investor.

By Charles D. Meyer

One of the most overlooked investment vehicles is the U.S. savings bond—the EE bond. Yet it currently offers a good rate of return relative to the amount of risk undertaken. In part, this is due to the fact that the risk inherent in any bond investment is reduced: There is no business or market risk, and both interest rate risk and purchasing power risk are limited by the floating interest rate feature currently offered by these bonds. Since it is a government-issued security, safety of principal is virtually guaranteed. In addition, EE bonds provide good liquidity along with substantial tax advantages and, on top of that, there are no purchase or redemption costs or commissions.

There are, of course, some disadvantages. The floating rate, for instance, makes it impossible to know precisely what return the bonds will have above the minimum. But they do provide a good investment alternative under a wide variety of circumstances.

If they are attractive, why do they appear to be neglected? There are several reasons which probably account for the reluctance to embrace EE bonds. The public is bombarded daily by media campaigns touting brokered investments, and the government has neither an effective media campaign nor a high degree of credibility.

Yet they are worth considering, and this article will present a closer look at the "stodgy" EE.

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How does it work?

The EE bond is an appreciation-type security that has a maturity of 10 years. It is purchased at a deep discount—50% of face value. For example, a bond with a $100 face value costs $50. The bonds are available in denominations (face amount) of $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000.

EE bonds purchased after November 1, 1982, offer a floating interest rate, with a guaranteed minimum of 7.5%, if held five years or longer. Accrued interest is realized upon redemption, since the bond is designed to reach its face value at maturity based on the guaranteed minimum interest rate. The actual redemption value, however, may be higher, reflecting the floating interest rates.

The interest rate on an EE bond held five years is based on 85% of the average market yield on five-year Treasury securities, compounded semiannually. The rates are adjusted every six months; Table 1 illustrates the process. The current six-month period rate (May 1, 1986, through October 31, 1986) is 7.02%. This rate is

Table 1. Semiannual market-based rates* for Series EE bonds

Bonds purchased	Annual percentage rates for semiannual periods: 1st period	2nd period	3rd period	4th period	5th period	6th period	7th period	8th period	Average rate
Thru 4/30/83	11.09%	8.64%	9.38%	9.95%	10.94%	9.49%	8.36%	7.02%	9.36%
5/1/83 to 10/31/83	8.64	9.38	9.95	10.94	9.49	8.36	7.02		9.11
11/1/83 to 4/30/84	9.38	9.95	10.94	9.49	8.36	7.02			9.19
5/1/84 to 10/31/84	9.95	10.94	9.49	8.36	7.02				9.15
11/1/84 to 4/30/85	10.94	9.49	8.36	7.02					8.95
5/1/85 to 10/31/85	9.49	8.36	7.02						8.29
11/1/85 to 4/30/86	8.36	7.02							7.69
5/1/86 to 10/31/86	7.02								

*These rates apply to bonds held five years or longer and to bonds purchased before November 1, 1982, when they are held to their first interest-accrual date beginning on or after November 1, 1987.

the first period rate for Series EE bonds issued during this time period; it is the second period rate for bonds issued during the previous semiannual period; and it is the eighth period rate for bonds issued at the beginning of the program.

The overall rate that an investor receives is based on the individual rates for the semiannual periods over the life of his bond. Thus, that rate cannot be determined until the last semiannual period of the bond's life.

Investors can look at the average rates, however. The average rate for bonds bought at the beginning of the market-based interest program is 9.36%. Bonds purchased during subsequent six-month interest accrual periods have different average rates, as shown in the last column of Table 1. These average rates will change every six months as a new six-month rate is averaged in with previous six-month rates.

Investors can draw some implications from the average rates, particularly as the bonds get older. For instance, bonds purchased at the beginning of the program—November 1, 1982, through April 30, 1983—have only two more semiannual periods to go to satisfy the five-year minimum that qualifies them for market-based rates. Since they have an average rate of 9.36%, it would take an average rate of 0.13% during the last two semiannual periods for these bonds not to have a yield higher than the 7.5% minimum if they were redeemed immediately after qualifying. However, if they were held to their final maturity of 10 years from the purchase date, the average market-based rate on their remaining time (12 periods) would have to exceed 6.26% for the bond to pay more than 7.5% upon maturity.

Another item to keep in mind is the minimum rate. Many EE bond investors were surprised that the latest semiannual rate dipped below 7.5%. However, the 7.5% minimum rate is a minimum guarantee of return over the life of the bond; it is not a floor rate. A dip below the 7.5% minimum in any particular period may be offset by higher rates during other periods.

Investors should also be aware that in order to receive both the minimum rate and the variable rate, they must hold onto the bond for at least five years. If the bonds are redeemed after one year, EE bonds earn 5.5%; this rate rises gradually thereafter. Only under special circumstances can EE bonds be redeemed within six months of their purchase date.

Series E or EE bonds purchased prior to November 1, 1982, retain their previous guaranteed minimum interest rate (ranging between 7.5% and 9.0%, depending on the date of issue) through their maturity period. These pre-November 1982 bonds did not have floating rates. Instead, the guaranteed minimum interest rate was periodically readjusted, and the maturity period varied with the guaranteed interest rate. Since this rate was readjusted a total of 19 times, the maturity periods for these bonds varied between four years and six months, and 11 years. However, anyone who currently holds an E or EE bond that was purchased prior to November 1, 1982, can "qualify" the bond for market-based interest rate adjustments if they hold the bond at least five years after November 1, 1982 (November 1, 1987).

The only practical method for determining the current value of E or EE bonds is to consult a table of redemption values. Department of the Treasury form PD 3600 is available for determining redemption values. A more useful redemption guide begins on page 75 of J.K. Lasser's "Your Income Tax" 1986 edition (always highly recommended and available in most bookstores). Banks can also provide redemption values, but cannot be counted on having redemption tables for distribution.

One other aspect of E and EE bonds that should be understood is the difference between "maturity" and "actual life." When an E or EE bond reaches its established maturity date, it has been the practice of the government to extend the life of the bond, including interest, beyond its original maturity. As the bonds approach the end of their original maturity period, the Treasury decides on extensions. Thus, decisions on extensions for Series EE bonds, first issued in 1980, will be made later in this decade. Historically, the actual life of the bonds has been extended to 40 years. Bonds held beyond a 40-year period traditionally have ceased to earn interest.

Finally, EE bond principal and interest is guaranteed by the U.S. government. If lost, stolen, mutilated, or destroyed, they will be replaced without charge upon application and will bear the original issue dates.

What are the advantages?

There are a number of distinct advantages that EE bonds offer:

- They are safe;
- They pay market-based interest with a guaranteed minimum;
- They are easy to buy and redeem, with no purchase or redemption costs;
- They come in various denominations; and
- They offer federal tax deferral and state and local tax exemption benefits.

The tax advantages of EE bonds are two-fold. First, they are exempt from state and local taxes. Second, they offer the option of deferring federal taxes on the accumulated interest. This is in contrast to zero coupon bonds, on which an investor must pay income taxes yearly on the accrued interest even though no actual payments are received.

There are two options available for reporting the taxable income from EE bonds for federal tax purposes. The standard procedure is for interest to accumulate tax-free until redemption. This postponement of income is advantageous for those expecting to redeem the bonds during a period of lower marginal tax rates than is currently being paid. The alternative is to file an election to pay taxes each year as the interest is earned. This strategy would be appropriate for anyone expecting to be taxed at a higher marginal tax rate in the future (when the bonds would either be needed or reach final maturity). If this method is elected, income from all EE bonds purchased in the current or future years must be reported.

At maturity, EE bonds may be exchanged for Series HH bonds in multiples of $500. HH bonds pay a fixed rate of 7.5% semiannual interest but allow the appreciated interest of EE bonds to be "rolled over" into the face value of the HH bond until redemption.

If titled properly, EE bonds offer the potential for income splitting among family members.

What are the disadvantages?

No investment is ideal, and investors should take a close look at the disadvantages before committing money.

The floating rate feature can be viewed as a disadvantage by some investors. For instance, investors who want to "lock in" rates above 7.5% are unable to do so with floating rate bonds. In addition, as mentioned previously, investors cannot determine in advance what their rate of return will be above the minimum.

EE bonds must be held for five years after the purchase date or November 1, 1982, to be fully qualified for market-based interest. Thus, they are no substitute for money market accounts or other short-term investments.

There is an annual purchase limit of $30,000 face value ($15,000 initial investment) per person.

There are also record-keeping requirements that become progressively tedious as the number of bonds increases.

Although EE bonds are registered securities, safekeeping of the bonds in a safety deposit box or safe storage is recommended. A listing for each bond indicating its serial number, purchase date, face value, and the owner, should be maintained in a location separate from the bonds.

Determination of the current value of each bond can only be accomplished by consulting a table of redemption values.

EE bonds are not easily transferred and they may not be used as collateral. To transfer or change ownership, the bonds must be redeemed and new bonds issued in the new owner's name. This transfer will create a taxable redemption for bondholders who have not made the special election to be taxed on a current basis.

EE bond planning opportunities

There are several planning opportunities offered by EE bonds. For instance, taxes can be deferred even longer by holding bonds until death. Beneficiaries need not pay income tax until they redeem them.

In addition, EE bonds purchased and registered exclusively in a child's name can be an effective method of income splitting for high-bracket parents. Have your child elect to pay taxes annually, to take advantage of his or her low tax bracket. Bonds subsequently cashed for college or other purposes can be cashed tax-free. This strategy would *not* work if the bonds were titled jointly with the parent. Minor children able to sign their name may redeem EE bonds, and parents and guardians may also redeem bonds titled to minor children. A Social Security number should be obtained for the child from the local Social Security administration office. In the first year, a federal tax return should be filed in the child's name, listing accrued interest as income and thus declaring that it is the child's intention to report savings bonds interest annually. Using this strategy, up to $1,000 interest per year may be accumulated without a tax liability. According to the Treasury, monthly savings of $25 begun at birth would yield $11,461 at age 18 assuming the guaranteed floor rate of 7.5%.

EE bonds make excellent gifts, especially to newborn children. Since 1982, the average market-based rates have been as high as 11.09% and as low as 7.02%. The average rate for a bond purchased at the inception of the market-based program has been 9.36% over that four-year period. The current rate in effect for the period through October 31, 1986, is 7.02%.

If you do decide to invest in EE bonds, make any purchases at the month's end, since EE bonds are dated and bear interest from the first day of the month in which purchased.

EE bonds are available at banks, savings and loan associations, and other financial associations. Many employers offer automatic payroll deduction programs, and banks offer "bond-a-month" plans allowing a depositor to purchase bonds through a system of regular monthly withdrawals from the depositor's account. Both of these are convenient methods of forced savings. Redemptions can be made at most banks, savings and loan associations, or other financial institutions.

Perhaps the best method for purchasing the bonds, however, is with the Federal Reserve Banks. This is accomplished through the mail, and forms for this can be easily acquired by calling or writing the bank. The Federal Reserve Banks are also the most knowledgeable should you have any questions regarding the bonds.