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Inflation-Adjusted U.S. Savings Bonds

The recent surge in price inflation has reduced the real interest rate on traditional Treasury bonds close to, and at times even below, zero. While the nominal return on these bonds is fixed, their real return will always be uncertain, because it depends on the future rate of price inflation. In contrast, inflation-adjusted I bonds provide a way for investors to obtain a steady, positive real return.

The inflation-adjusted return on long-term bonds, especially Treasury securities, has fallen to an exceptionally low level, apparently because the rate of price inflation has been higher than investors expected. The Consumer Price Index increased by 4.3 percent in the 12 months ended in October, up from a rate of 1.7 percent just 18 months ago. Long-term interest rates, however, have not increased as much: the rate on 10-year Treasury notes is currently about 4.5 percent, compared with 4.0 percent in early 2004.

Consequently, the inflation-adjusted rate on 10-year Treasuries (the nominal rate minus the 12-month change in the CPI) has decreased from about two percent in early 2004 to nearly zero today. In other words, at their current yields, Treasuries provide an interest income that is barely sufficient to compensate for the erosion of the dollar's purchasing power during the past year. At various times in the past year, their real yield has been negative.

Real interest rates rarely remain zero or negative for long. If the rate of price inflation remains elevated, investors' inflationary expectations will change and they will likely demand higher nominal interest on Treasuries. However, if they think the recent spike in price inflation will be short-lived, nominal rates on long-term bonds may not increase much.

Either way, the real returns on standard Treasury securities will remain unpredictable, because there is no guarantee that inflationary expectations will match the actual rate of price inflation in the future. Investors may win (if the future rate of price inflation over the life of their bonds is less than expected) or lose (if it is more than expected), but the bottom line is that their real return cannot be known with certainty.

Two alternatives to standard Treasuries do provide a guaranteed, fixed real return: Treasury Inflation-Protected Securities (TIPS) and, our focus here, I bonds.

The Treasury began offering I bonds, a type of savings bond, in 1998. The nominal interest rate on I bonds is variable and is pegged to changes in the CPI. If price inflation increases, the I bond rate increases, thereby compensating the bondholder for the dollar's loss of purchasing power. I bonds thus work very differently from standard Treasuries. With the latter, your nominal interest rate is fixed but your real rate varies; with inflation-adjusted I bonds, your nominal interest rate varies but your real rate is fixed.

The nominal interest rate on an I bond is a combination of a fixed rate plus an adjustment for price inflation. The fixed rate is selected by the Treasury and remains the same for the 30-year life of the bond. The inflation adjustment changes every six months and is based on the latest six-month change in the CPI. Each year on November 1, the Treasury announces an inflation adjustment based on the change in the CPI from the previous September through March; on May 1, it announces a new inflation adjustment based on price inflation from March through September.

Last month the Treasury announced the latest rates. I bonds purchased between November 1, 2005 and April 30, 2006 will earn an annual rate of 6.73 percent for the first six months after purchase. This rate includes a 1.0 percent fixed rate, which will remain in effect for the life of the bond, and an annualized inflation adjustment of roughly 5.7 percent (the annual rate of increase in the CPI between March and September 2005). Next May the Treasury will announce a new inflation adjustment, based on what happens to the CPI between now and then.

Although the Treasury announces new rates in May and November, the rates on individual I bonds are adjusted on the six-month anniversary of their purchase. Thus if you buy a bond in January, its rate will change at the beginning of every January and July. For example, between January and July 2006 it will earn the 6.73 percent rate announced earlier this month. From July through January 2007, it will earn the rate announced next May, and so on.

How Have They Done?

The fixed real rate that an I bond earns depends on the date it was issued. For bonds purchased between now and next May it will be 1.0 percent, but for bonds that were purchased between May 1 and November 1 of this year, it is 1.2 percent. Since introducing I bonds in 1998, the Treasury has periodically changed the real rate to reflect the downward trend in the real rates available on standard Treasury securities. The highest real rate ever offered was 3.6 percent, payable for the lifetime of I bonds purchased in 2000. Adding in the current adjustment for price inflation, these bonds will pay an annual nominal interest rate of 9.4 between now and next May.

With the inflation-adjusted yield on standard Treasuries currently at its

lowest level in over 20 years, it is not surprising that the Treasury is offering a very low real rate on I bonds. When the general level of real rates increases, the Treasury probably will raise the guaranteed real rate on future issues of I bonds. In the meantime, even at the current low rate, I bonds are providing a slightly higher real return than the zero-to-negative real interest rate that standard Treasuries have recently provided.

Moreover, when the real rates on alternative investments do rebound, you can cash in an I bond with minimal penalty. You must hold them for at least a year, and if you redeem them within the first five years, you forfeit the three most recent months of interest.

Unlike conventional Treasury securities, the price of an I bond does not vary inversely with its yield. If you buy a standard bond today and interest rates subsequently increase, the market value of the bond will fall. But the redemption value of an I bond will simply be its purchase price (i.e., its face value) plus any accrued interest.

That last point is an important caveat for investors seeking current income from bonds. I bonds, like EE savings bonds, do not pay cash income; the interest accrues and is added to the bond monthly, and is paid when you cash in the bond.

In addition to offering a guaranteed real return, I bonds offer other advantages. The interest is exempt from state and local income tax, and bondholders have the option of deferring federal income tax until the bonds are redeemed or until they stop earning interest after 30 years, whichever comes first. If the bonds are used to pay for college expenses, the interest may be exempt from federal tax. For more information on this education-related tax break and its eligibility requirements (some of which apply when you buy the bond) see IRS Publication 970, "Tax Benefits for Education."

Paper I bonds are available in denominations ranging from $50 to $10,000 and can be purchased at most banks. You can also buy electronic I bonds online for as little as $25, using a TreasuryDirect account at the U.S. Treasury. For more information, visit www.treasurydirect.gov or www.savingsbond.gov. ❑

SECTION 529 PLANS: CLEARING UP THE CONFUSION*

Since their introduction a few years ago, Section 529 savings plans have become a popular way to help meet the escalating cost of a college education. However, the plans are confusing, the fees can be high, and tax treatment varies from state to state. Their advantages and disadvantages are discussed below.

According to the College Savings Plans Network, between 2002 and 2004 the total assets in 529 plans increased from $27 billion to $65 billion and the number of 529 accounts surged from 4.4 million to 7.2 million. More liberal tax treatment included in the Tax Relief Act of 2001, coupled with sharply rising tuition costs, has fueled this increase.

Named for Section 529 of the Internal Revenue Code, these tax-favored investment and savings plans are set up and operated by each state to help families save for college costs. While different states have different rules and investment options, they all offer powerful savings and tax incentives. Although contributions are not eligible for a federal tax deduction, investment earnings in the plan grow tax-free and withdrawals used to pay for a beneficiary's qualified educational expenses are exempt from federal taxes (although, in some states, they may be subject to state taxes). Individual states may offer other incentives, such as an up-front deduction for contributions.

Another attractive feature is that the donor maintains control of the account so the beneficiary cannot access the funds. This offers a big advantage over custodial accounts set up under the Uniform Transfers to Minors Act (UTMA), where the child takes control once he or she reaches the age of majority. Everyone can use a Section 529 savings plan, without income limits on participation, and the amounts you can contribute are substantial (well over $100,000 in most states). As there is often no residency requirement, you can set up plans in more than one state.

Despite these attractive features, recent investigations by industry and government regulators also point to the plans as a source of scrutiny, controversy, and confusion. Because they are issued by states, Section 529 Plans are not regulated by the Securities and Exchange Commission and are not required to include a standardized fee schedule and historical return disclosure, as mutual funds are. Without this key information, determining the true cost of a 529 Plan and comparing it to other plans has proven to be extraordinarily difficult for many people.

Regulators have become concerned that some brokers and financial advisors, who account for most plan sales, take advantage of this lack of clarity by selling high-cost plans that may not be suitable for their clients. The National Association of Securities Dealers (NASD) is currently investigating 20 brokerage firms and their sales practices to determine whether financial advisors steered too many clients toward high-commission 529 plans outside their home states without explaining the tax advantages of in-state plans. In October, it ordered one of these firms, Ameriprise Financial Services, to pay $1.25 million in fines and restitution for inadequately supervising brokers who sold such plans.

Moreover, a study by Drs. Raquel Meyer Alexander and LeAnn Luna of the University of North Carolina last year drew the disturbing conclusion that the states providing the *largest* state income tax deduction for residents' contributions are likely to have the *smallest* number of accounts, while 529 plans with *higher* fees have more accounts and more assets than plans with *lower fees*. Meanwhile, a Securities and Exchange Commission task force is investigating 529 plan fee structures and investor disclosures.

Some help for investors came last year when the College Savings Plans Network, an affiliate of the National Association of State Treasurers, approved voluntary guidelines for 529 disclosures. The Municipal Securities Rulemaking Board, a self-regulatory agency created by Congress, is working to create standardized 529 disclosure documents. At this point, however, the quality and clarity of disclosure varies widely from plan to plan.

* This article is by Marla Brill, AIER Research Fellow.

As states and regulators hash out the details, families facing ever-mounting college expenses are left to sort through Section 529 plans largely on their own. The differing investments, expenses, and tax treatment of each state's plan make comparison and evaluation extremely difficult, so it is critical to do research and ask questions before buying. Below are some key issues and plan features that should help guide your search.

Prepaid vs. Savings Plans

Section 529 plans fall into two broad categories. Participants in "prepaid tuition plans" purchase tuition "certificates" or "credits" that go toward future payment of tuition and required fees for the beneficiary. Program trust funds, funded by participant contributions, are managed to generate an investment return sufficient to cover a specified level of future tuition payments. Under a 529 "savings program," the newer and more common version, participants contribute to an account that invests in mutual funds and other investments. Most of these are sold through financial advisors, although there are a number of direct investment plans as well. You can use the money from savings plans to cover tuition and fees, as well as books, supplies, and in many cases, room and board.

Prepaid plans can provide some level of assurance for risk-averse investors because they offer a defined benefit or specified return in the form of a specified number of tuition units or credits, which are unaffected by increases in tuition. By contrast, the money a savings plan investor has available to pay for college depends on both the amount of contributions and the investment results of the account. However, prepaid plans have a number of restrictions. Usually, the beneficiary must meet state residency requirements and the programs are geared toward meeting costs at a pre-selected roster of in-state public or private schools. Most savings plan programs are open to residents of any state and the money in the account can be used to pay tuition and other expenses at any college.

In 2003, TIAA-CREF became the first (and still only) firm to introduce a non-state sponsored prepaid contract plan called Independent 529 Plan. Unlike traditional state-run prepaid plans, it has no residency restrictions and participants can choose from among approximately 250 participating private colleges around the country. A list of those colleges and more information on the plan is available at www.independent529plan.org.

State Tax Treatment

State tax treatment of college savings plan contributions and withdrawals vary widely from state to state. In Colorado, contributions (excluding rollovers) are fully deductible from taxable income for state residents. In Rhode Island, residents filing jointly may only deduct a maximum of $1,000. Twenty-five states and the District of Columbia offer a tax deduction or credit for contributions, and no state provides a deduction or credit to its residents for an out-of-state plan. Many states permit tax-free withdrawals for residents who use them to pay qualified educational expenses, even for out-of-state plans. Others allow tax-free withdrawals for their own plans, but tax distributed earnings from other state plans.

The issue that the NASD is examining—whether brokers push out-of-state plans because they offer the highest commissions, yet neglect to tell investors about the tax advantages of in-state plans—should be high on your list of questions. Although an out-of-state plan can sometimes offer a better deal than one offered by your home state if it has lower expenses or better investment options, it is important to understand why someone is recommending it. Ask why your financial advisor does not recommend your home state's plan if that is the case, and obtain and information on that plan and the tax treatment of contributions, earnings, and withdrawals before making any decisions. An excellent source of information on 529 Plans offered in all 50 states can be found at the web site of the College Savings Plans Network (www.collegesavings.org).

Keep in mind that if you move, you may lose any state tax deduction on future contributions and state tax exemptions on withdrawals. Most states require a "recapture" of prior deductions on non-qualified withdrawals, and some states require them for rollovers into out-of-state plans.

Expenses

A number of plans have drawn criticism because the high fees they charge, while others are relatively reasonable. Some have a one-time enrollment fee, which usually ranges from $25 to $100. Many charge an account maintenance fee of as much as $50 a year, which may be waived for larger accounts. All 529 Plans have a program management fee that covers the costs associated with the outside program manager or state agency that administers the plan. This expense can often exceed one percent a year, although many plans have program fees of 0.5 percent or less. Another fee covers the expenses of the underlying mutual funds. These can be less than 0.4 percent for low-cost index funds to over two percent for higher-cost funds. Some programs lump the program management fee mutual fund expense together into one figure.

If you work with a financial advisor who charges commissions, you will also incur a sales charge, which can run as high as 5.75 percent of your contribution. If you work with a fee-only advisor or do your own research, you can buy a direct-sold plan that does not have a sales charge. In a number of states, residents may purchase direct-sold programs, but non-residents must buy them though a financial advisor or pay the higher costs associated with shares sold through advisors. For those interested in comparing costs, the NASD offers a useful cost analyzer at www.nasd.com/529analyzer.

Control of Investment Options

Most states offer age-based and static investment options. Under a static arrangement, investors choose from among several "funds of funds" consisting of stocks, bonds, or a combination of both, and the allocation remains fixed. An aged-based portfolio is a fund of funds where the asset mix becomes more conservative as the beneficiary approaches college age. Account owners can change investments once every calendar year. Switching to another state's plan is generally permitted once a year.

Researching the investment performance of various state plans is difficult, since most state programs are relatively new and have only a short track record. As a rule of thumb, it is best to go with an investment management firm you have used before and feel comfortable with, preferably one that offers

low-cost index funds.

Financial Aid

Assets in a 529 savings plan are considered an asset of the account owner. As such, they usually reduce a student's eligibility for financial aid, but the negative effect is often less than it is for other types of college savings. Tax-free withdrawals from 529 savings accounts owned by a parent or student are not included in financial aid income calculations, and do not reduce financial aid eligibility.

Note that financial aid rules vary, depending on the type of aid and the school. Loans or scholarships awarded by individual schools, which can be a significant component of a financial aid package, may or may not conform to the rules for federal financial aid. Also keep in mind that prepaid tuition plans are treated differently in calculating federal financial aid than 529 savings plans. Because payments from tuition contracts are considered an additional "resource," they reduce financial aid on a dollar-for-dollar basis. If you think your family may be eligible for financial aid from either government or private sources, it is important to thoroughly investigate the impact that a 529 plan may have on any awards.

Other Considerations

Congress authorized the tax-free treatment of distributions from 529 savings plans used for qualified higher education expenses as part of the Economic Growth and Tax Reconciliation Act of 2001. However, under the Act, that treatment is now scheduled to "sunset" on December 31, 2010, unless renewed by Congress. This means that anyone with a child who does not finish college by then may not be able to take tax-free withdrawals when they are needed.

Another consideration, critics say, is that because some 529 plans are loaded with fees, consumers may be better off saving for college in a taxable account stocked with low-cost, tax-efficient investments, such as index funds. The approach is more flexible because account owners can choose the investments they want, switch investments as often as they like, and claim a capital loss deduction if an investment loses value. In other situations, a Coverdell education savings account, or a traditional or Roth IRA, make the most sense. ❑

Gold at $500

Gold bullion closed in London at $502.50 per ounce on December 2. The P.M. fix had not been above $500 since 1987. Even though, as shown in the chart below, the dollar price of gold had been steadily increasing for five years or so, it was the $500 "milestone" that put gold back in the headlines of the financial press. Many attributed the strengthening of the gold price to the weakening dollar. Indeed, the trend of the dollar price of gold and the price of euros in dollars closely paralleled each other during 2002, 2003, and 2004. The price of gold in euros was essentially flat during those years. Its monthly average did not exceed its level in the spring of 2002 until last June. The dollar price increased more than one third during the same period.

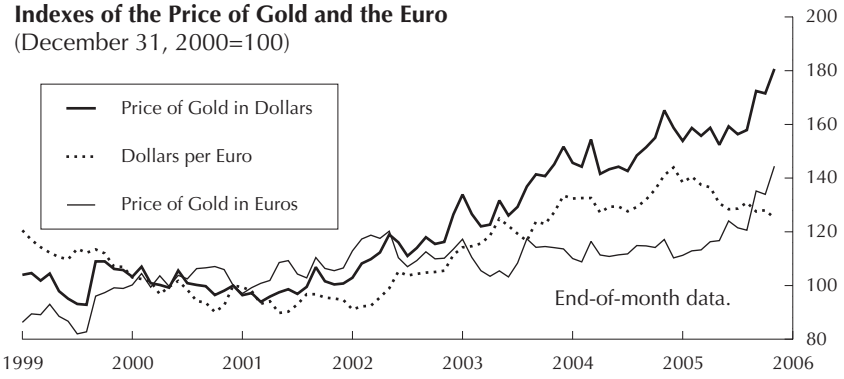
If the increasing price of gold was merely a reflection of the foreign exchange value of the dollar, then a strengthening of the dollar could have been expected to be accompanied by a decrease in the dollar price of gold. But this is not what happened. Since the end of last year, the dollar price of gold has *increased* by nearly 14 percent, while the dollar price of euros has *decreased* by roughly the same amount (note how the two curves have diverged during recent months).

That the price of gold has increased in dollars and euros (as well as other major currencies) has been seen by many observers as an indication that investors have been providing against an acceleration of the loss of purchasing power of paper money, *i.e.*, that they have come to expect higher rates of general price inflation here and abroad. However, much of the recent sharp run-up in the gold price has apparently reflected speculative buying on the basis of its "price momentum."

Those who are buying gold simply because its price has been going up will probably tire of it if the price levels off (even temporarily). Nevertheless, it appears likely that overall demand will remain strong as the increasing prosperity of China and India (as well as the current high oil price) means increased demand among groups in Asia and the Middle East with long-standing traditions of holding gold as a store of value.

As for supply, it will be several years before mining projects that were "mothballed" when the price of gold was low can be brought on stream. However, if the price of gold continues to increase markedly, it can be expected that the world's central banks, which still hold approximately half of all gold that is in "good delivery" form, will at some point become tempted to become sellers. In other words, we have no way of determining how long the "bull market" in gold will last, and neither does anyone else. As we have often stated, the reason to own gold is not to *make* money, but to *have* money in any and all circumstances.

Indexes of the Price of Gold and the Euro
(December 31, 2000=100)



PRICE OF GOLD

	2003	*2004*	*2005*	
	Dec. 11	*Dec. 9*	*Dec. 1*	*Dec. 8*
Final fixing in London	$404.10	$437.10	$499.75	$515.70

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