I Bonds as an Emergency Savings Alternative

There is an old rule of thumb in financial planning that says you should always keep six months of living expenses in an emergency savings fund that will be readily available and secure. There is a downside to keeping too much in your emergency savings, however, as there are opportunity costs for any assets you keep out of the market. In today's low interest environment, comparatively safe investments like CDs, money market funds, and savings accounts forego any type of meaningful returns, and with inflation surging, you are likely diminishing the purchasing power of your savings by keeping it in the bank.

Any properly managed investment portfolio will take into account the need for liquidity and will be structured according to the level of risk you are comfortable with, but many investors rest more easily knowing they have a rainy-day fund readily available and free from the volatility of the market. For these investors, Series I Savings Bonds, known as inflation bonds or I bonds, may be a great alternative to traditional savings options.

I bonds earn two types of interest: an interest rate that is fixed for the life of the bond and an inflation rate that is adjusted each May and November based on changes in the consumer price index (CPI). The fixed rate is generally very low, currently at 0%, but with inflation surging, new I bonds issued through the end of October 2022 will earn a rate of 9.62%. That represents the highest yield since the bonds were introduced in 1998, and is much higher than other secure fixed income or savings options.

As attractive as the returns on I bonds are, the limits on how much you can purchase mean they cannot be a substantial part of your investment portfolio. I bonds must be purchased directly from the Treasury Department, and the most you can buy is $10,000 a year per person, though you can buy an additional $5,000 in paper bonds if you direct your tax refund toward the purchase. Still, having $10,000 in emergency funds earning nearly 10% is far better than keeping $10,000 in a savings account that earns only 2%.

There are some important caveats to keep in mind if you intend to use I bonds as your rainy-day fund. The first is that I bonds must be held for at least one year, so be sure you have an alternative emergency fund for the first year of ownership. Also, if you hold your I bonds for fewer than five years, when you sell them you will not receive the last three months' worth of interest. Another important thing to keep in mind is that checks cannot be written directly against your TreasuryDirect account, which is what you use to purchase I bonds, so in a true emergency, it may still take a few days to liquidate and transfer money to another bank account to cover an emergency expense. Nevertheless, I bonds can be a great way to attain the peace of mind that comes from an emergency fund while avoiding the anemic returns of most money market alternatives.