Treasury STRIPS

Wealth Management

Treasury STRIPS, or Separate Trading of Registered Interest and Principal of Securities, are an investment product created by disassembling a coupon-paying Treasury bond to manufacture several zero-coupon bonds from the original bond's interest and principal payments. We discuss how the bonds work and how this asset class may fit into a larger fixed income strategy.

What are Treasury STRIPS?

Treasury STRIPS are a type of zero-coupon bond. In general, a zero-coupon bond is any bond which doesn't pay periodic interest. The investor's earnings grow over the life of the bond as the deeply discounted purchase price gradually rises toward the bond's par value as maturity approaches. Though they do not pay periodic interest payments, the deeply discounted market price of a zero-coupon bond results in an annual yield similar to coupon bonds.

Zero-coupon Treasury bonds are called Treasury STRIPS. Unlike regular Treasury bonds, Treasury STRIPS are not issued directly by the U.S. Department of the Treasury; they are bought, held, sold, and redeemed through financial institutions. Treasury STRIPS are created through a process aptly referred to as stripping, where each cash flow from the original bond becomes a separate security.

To illustrate this process, suppose a $100 million face value 10-year Treasury note paying a coupon rate of 10% is purchased to create zero-coupon Treasury securities. The cash flow from this bond would be 20 semi-annual payments of $5 million each, plus one final payment of $100 million. Receipts are then issued to coincide with the maturity date and value for each of the coupon and final maturity payments. This process creates a total of 20 new securities with a maturity value of $5 million each, as well as 1 new security with a maturity value of $100 million. These new securities will be sold to investors at price that is deeply discounted relative to the face value, reflecting current market yields.

Why buy Treasury STRIPS?

Treasury STRIPS can provide investors with a number of advantages:

- **Elimination of reinvestment risk** — One of the main benefits of purchasing Treasury STRIPS is that the absence of periodic coupon payments eliminates reinvestment risk. Reinvestment risk is the risk that an investor may not be able to reinvest coupon payments at a comparable rate in a new security, thereby lowering total return. Since zero-coupon bonds such as STRIPS do not pay periodic interest payments, reinvestment risk is eliminated.
- **Safety** — Depending on the specific security, zero coupon Treasuries represent either a claim on an underlying Treasury security held in trust or actual ownership of the underlying Treasury security. In either case, the underlying securities are guaranteed by the full faith and credit of the U.S. government.
- **Liquidity** — The secondary market for Treasury STRIPS is actively traded, with more than $460 billion outstanding according to the U.S. Department of the Treasury.
- **Maximum use of investment dollars** — Since zero coupon Treasuries are discounted from their maturity value, the investor doesn't have to invest as much initially compared to purchasing the underlying bond. For example, purchasing $1,000 of a 30-year Treasury STRIPS yielding 5% would cost approximately $227.28 and mature at $1,000. This feature makes Treasury STRIPS an excellent vehicle for long-term wealth planning, such as accumulating savings for a child's college education.

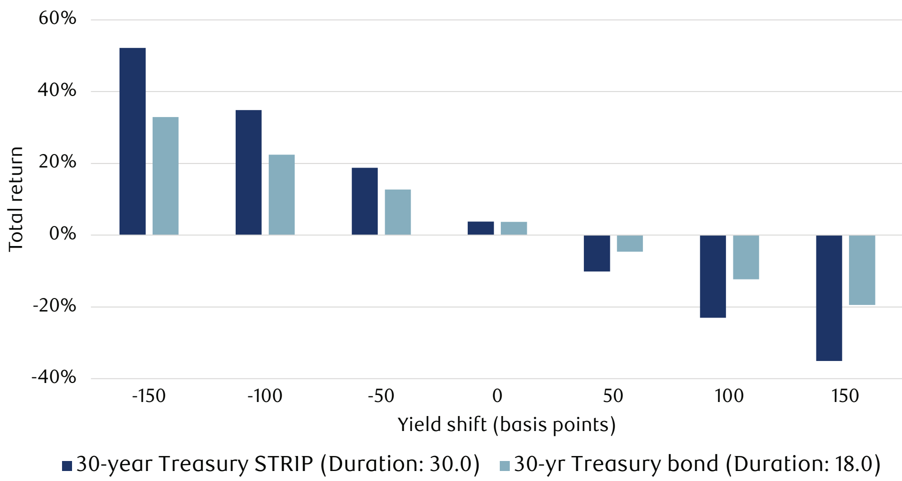
Duration considerations

Duration, or a bond's market price sensitivity to changes in market interest rates, is an important consideration when investing in zero-coupon bonds. These tend to have higher duration characteristics relative to bonds of a similar maturity that do pay coupons. As a result, zero-coupon bonds can offer greater price appreciation potential in a declining interest rate scenario. On the other hand, when interest rates rise, zeros may experience more severe market price declines.

Investors who plan to hold a zero-coupon bond until maturity may be less concerned about temporary price declines because, absent a default, bond prices ultimately mature at par. Investors who believe interest rates are headed lower may consider employing zero-coupon bonds in a long duration strategy to potentially capture greater total returns.

Greater duration can produce more price volatility

Hypothetical change in market price for a 30-year STRIPS and bond over a 6-month time horizon



Figures are for illustrative purposes only.

Tax treatment

The IRS considers zero-coupon bonds as original issue discount debt obligations. This means that as the bond accretes over time, the accumulated interest is federally taxable each year, even though the investor does not receive any payments. Due to this tax treatment, many investors prefer to use zero-coupon bonds in tax-advantaged accounts such as 529 plans and IRAs.

Additionally, like their coupon-paying counterparts, Treasury STRIPS are exempt from state income tax, providing a tax advantage for investors in high income-tax states.

Conclusion

Treasury STRIPS offer several advantages, including a state income-tax exemption, safety, liquidity, and elimination of reinvestment risk. Investors should be cognizant of the federal tax treatment and long duration characteristics. Treasury STRIPS may be a suitable choice for investors seeking the power of compounding.

24-36-02560_3685 (10/24)