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Pros and Cons of Zero-Coupon Bonds

This isn't the investment for you if your retirement is years away.

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I am 42 years old and interested in zero-coupon bonds to supplement my retirement savings. What are the pros and cons?

With retirement years away for you and today's low interest rates, we'd advise against buying zeros. These bonds don't make regular interest payments. Instead, they're sold at a big discount to face value; when they mature, you collect the full amount. Their big advantage is that you know how much you'll collect a certain number of years from now.

In mid June, for example, you could have bought a U.S. Treasury zero for $341 that matures in August 2027 at a face value of $1,000. That's an annualized return of 5.4%. But inflation, which has averaged about 3% over the past 20 years, will eat up a big part of that return. “Amounts due at maturity may not have the purchasing power you thought they would,” says Paul Winter of Five Seasons Financial Planning in Salt Lake City.

And if interest rates continue to rise, as they did in late spring, zeros, unlike regular bonds, don't give you the opportunity to reinvest your interest at higher yields. Moreover, if you hold zeros in a regular account, you'll have to pay taxes each year on so-called phantom income from interest you haven't yet received.

With 20 years or so to go before you retire, you'll almost certainly do better with a diversified portfolio of stocks, although they'll probably offer a bumpier ride along the way.

If the certainty of zeros still appeal to you, Winter suggests this strategy: Put some money in zeros that mature in 20 years. Five years from now, buy more zeros that mature 20 years from that point, and so on. If interest rates rise, you'll be able to invest at least some of your money at higher yields.

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