Zero coupon Treasury securities

Zero coupon Treasury securities are made up of an array of products with acronyms such as STRIPS, TIGRs, CATs, and LIONs. Despite the assortment of products, the underlying feature common to all these products is that they are backed by U.S. Treasury bonds. The following information will explain how zero coupon bonds work, as well as explain some of the differences among the various product categories.

What are zero coupon Treasuries?

In general, a zero coupon bond is any bond which doesn't pay periodic interest. Earnings (interest) accrete over the life of the bond as the difference between a deeply discounted purchase price and the bond's maturity value. Zero coupon bonds are priced to earn yields prevailing in the current market.

A zero coupon Treasury bond is simply a zero coupon bond on which payment is derived from an underlying Treasury security. This bond is created by taking a Treasury note or bond and first separating its coupon payments from the final principal payment in a process called coupon stripping. After this "stripping" process, securities are issued to match the maturity of each of the coupon payments with a final maturity payment. 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 20 coupon strip receipts with a maturity value of $5 million each, and one maturity receipt with a principal value of $100 million. These newly created strips are sold as separate securities. The price of the receipts would be discounted to reflect current market rates. This general process is the same for all of the zero coupon Treasury products.

Why buy zero Treasuries?

Purchasing zero coupon Treasury securities provides investors with a number of advantages:

- **Guaranteed return/reinvestment risk eliminated —** One of the main benefits of purchasing zero coupon Treasuries is that the investor earns a guaranteed return while eliminating reinvestment risk. With conventional Treasury bonds, coupon payments received over the life of the bond must be reinvested, possibly at lower rates. Zero coupon bonds eliminate this risk since there are no periodic payments. The investor's return is generated over the life of the bond as the interest accumulates, a process called accretion.
- **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 in zero coupon bonds is actively traded, with many zeros enjoying considerable liquidity.
- **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, 7% zero coupon Treasury bond would cost only $126.90 and mature at $1,000. This feature makes zero coupon bonds an excellent vehicle for long-term financial planning, such as accumulating savings for a child's college education.

Treasury zero product categories

The three product categories of Treasury zero coupon bonds evolved over time as a response to the prevailing market conditions at the time.

Proprietary or trademark products

These zero coupon Treasury securities were first created in the early 1980s by both Merrill Lynch and Salomon Brothers. The procedure was to purchase Treasury bonds and deposit them in a bank custody account. The firms then issued receipts representing an ownership interest in each coupon payment and maturity value of the underlying Treasury bond in the account. Although the receipts created aren't issued by the U.S. Treasury, the underlying bond deposited in the bank custody account is a debt obligation of the U.S. Treasury, which assures payment. Since these first products were created, other investment banks followed by creating their own zero coupon products associated with their particular firm. Most of these products were issued with names that created “animal” acronyms such as CATS, TIGRs, LIONS, etc. Although at one time the liquidity of these trademark products was limited, now they are actively traded on the secondary market.

Treasury receipts

Treasury receipt products were created as a generic product not tied to any one firm. A group of primary dealers in the government market agreed to issue these generic receipts to be traded in the secondary market. Thus, receipts represent ownership of the actual Treasury security.

Treasury STRIPS

The rapid growth of the zero coupon Treasury market drew the attention of the U.S. Treasury, which announced its own zero coupon program in 1985. From that point on, all note and bond issues with maturities of ten years or more were eligible for stripping into their component pieces.

Initiation of the Treasury STRIPs program effectively ended new issuance of the proprietary trademark and Treasury receipt zero products. Existing issues of these two products continue to be traded on an active secondary market, although Treasury STRIPs are the most actively traded and most liquid of the three product categories.

What are FICO strips?

FICO strips are zero coupon bonds issued by Financing Corporation, a U.S. Government agency. They’re called “strips” because they’re created by taking standard FICO bonds and separating or “stripping” the interest payments from the final principal payment. Each of the interest payments and the principal amount become separate securities with maturities to match the interest payment dates and final maturity of principal. Since there are no regular coupon payments, interest accretes as the difference between an original discounted purchase price and the final maturity value.

Tax treatment

One important point for zero investors to know is that, as a zero bond accretes (accumulates interest) over time, the earnings are federally taxable each year, even though the investor doesn’t receive any payments. The IRS considers zero coupon bonds as original issue discount debt obligations. Due to this tax treatment, many investors prefer to use zero coupon bonds in tax-advantaged accounts such as pension funds and Individual Retirement Accounts.

Conclusion

Zero coupon Treasury securities come in a variety of options for the individual investor. Regardless of the product, each offers the advantages of safety, liquidity, guaranteed return, no reinvestment risk, and state tax exemption. Investors seeking the power of compounding should consider zero coupon Treasuries.

