

DON'T BE AFRAID OF PREMIUM BONDS

Fixed Income Commentary

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Dan Skolochenko is a fixed income portfolio manager and trader in our San Francisco office with more than 13 years of industry experience. Prior to joining the firm in 2005, Dan held fixed income investment positions with The Boston Company and MFS Investment Management. He earned a Bachelor of Science with a concentration in economics from the University of North Carolina at Greensboro and a Master of Science with a concentration in finance from Boston College.

Some investors avoid buying premium bonds under the perception that in paying a price greater than par and receiving only face value at maturity, they are incurring a loss on their investment. The following article refutes the fallacy that premium bonds are a losing investment, and explains how municipal bonds purchased at a discount may incur unfavorable tax treatment.

Consider a 10-year bond priced at \$110. If an investor purchases and then holds this bond until maturity, he/she will receive par (\$100) back. On the surface it may appear that the investor is “locking in” a loss of \$10, but the purchase and redemption prices are only half the story. The often overlooked side of a premium bond investment is that the premium buys a higher level of income over the life of the bond, and these higher cash flows cumulatively make up for the premium paid at purchase.

A bond investor knows the exact timing and amount of every payment they are to receive. A bond's price is simply equal to the sum of all those future cash flows, with each payment discounted by the prevailing market yield (known as yield to maturity, or YTM). Since coupons can vary among different bonds, the offering price is not a good determinant as to whether a bond represents an attractive investment opportunity.

Consider the following example:

An investor has the choice between two \$100,000 investments. Both are 5 year bonds issued on Jan 1, 2011 and maturing on Jan 1, 2016. Both are available at a YTM of 3.00%.

Bond A is a par bond- it pays a 3% coupon.

Bond B is a premium bond- it pays a 5% coupon.

The tables below map out all cash flows for each bond, and also list each cash flow's present value (coupons are semiannual, and each payment is discounted by the YTM).

Note that the total cash flows for bond B are \$10,000 higher than those for Bond A, and that the difference is very close to the premium level on the bond. Also note that both bonds provide a similar total gain over the investment period. “Total Gain” is not an effective metric for choosing between two investments, but is provided above to illustrate that Bond B is NOT a losing investment. As demonstrated in this example, cash flows over the life of Bond B more than offset the premium price paid upfront, and in the end provide a net positive return.

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PAR BOND - A		PREMIUM BOND - B	
Mty	1/1/16	Mty	1/1/16
Par Amount	100,000	Par Amount	100,000
Coupon	3.00%	Coupon	5.00%
YTM	3.00%	YTM	3.00%
Price	\$100.00	Price	\$109.22
Total Cost	\$100,000.00	Total Cost	\$109,222.18

Time (yrs)	Date	Cash Flows	PV of Cash Flow	Cash Flows	PV of Cash Flow
0	1/1/11				
0.5	7/1/11				
1	1/1/12	1,500	1,477.83	2,500	2,463.05
1.5	7/1/12	1,500	1,455.99	2,500	2,426.65
2	1/1/13	1,500	1,434.48	2,500	2,390.79
2.5	7/1/13	1,500	1,413.28	2,500	2,355.46
3	1/1/14	1,500	1,392.39	2,500	2,320.65
3.5	7/1/14	1,500	1,371.81	2,500	2,286.36
4	1/1/15	1,500	1,351.54	2,500	2,252.57
4.5	7/1/15	1,500	1,331.57	2,500	2,219.28
5	1/1/16	1,500	1,311.89	2,500	2,186.48
5	1/1/16	100,000	1,292.50	2,500	2,154.17
		100,000	86,166.72	100,000	86,166.72
Total Cash Flows		115,000	100,000.00	125,000	109,222.18
Total Gain (ignores discounting)		\$15,000.00		\$15,777.82	

Note: For illustrative purposes only and not a guarantee of future performance. "Total Gain" ignores the timing of cash flows and the fact that Bond B represents a larger investment (\$109,222 versus \$100,000). Note that the total cash flows for bond B are \$10,000 higher than those for Bond A, and that the difference is very close to the premium level on the bond. Also note that both bonds provide a similar total gain over the investment period. "Total Gain" is not an effective metric for choosing between two investments, but is provided above to illustrate that Bond B is NOT a losing investment. As demonstrated in this example, cash flows over the life of Bond B more than offset the premium price paid upfront, and in the end provide a net positive return.

Rather than assessing a bond by its dollar price, the best determinant of a bond's attractiveness is its YTM. YTM considers both the timing of cash flows and the amortization of premium, and represents the overall internal rate of return (IRR) earned on a bond investment (assuming you hold until maturity). Since each bond in the example above provides a YTM of 3.00%, the investments above should be regarded as equally attractive. However, taking tax implications into consideration may cause the premium bond to be favored, especially in the municipal bond sector.

While the interest income on municipal bonds is typically tax-exempt, municipal bonds purchased at a discount can trigger a portion of the accretion (price increase over time) to par to become a taxable event. Portions of the accretion may qualify as capital gains and/or ordinary (non-exempt) income, payable when the bond matures or is sold. The specific tax rules regarding discount bonds are complex and beyond the scope of this article, but the takeaway should be that discount bonds introduce the risk of taxability to a portfolio.

For this reason, it may not be advantageous to purchase bonds priced near or below par value. Municipal discount bonds thus tend to be less liquid, and may not receive full value if sold prior to maturity. This is why premium bonds offering coupons in the 4.0 - 5.5% range tend to be the most widely issued, and are the preferred structure for the majority of institutional buyers.

A bond offered at a premium should not be rejected for the sole reason of having a dollar price above par, and will likely protect the buyer from tax considerations associated with discount bonds. ■

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