ADVISORS ASSET MANAGEMENT

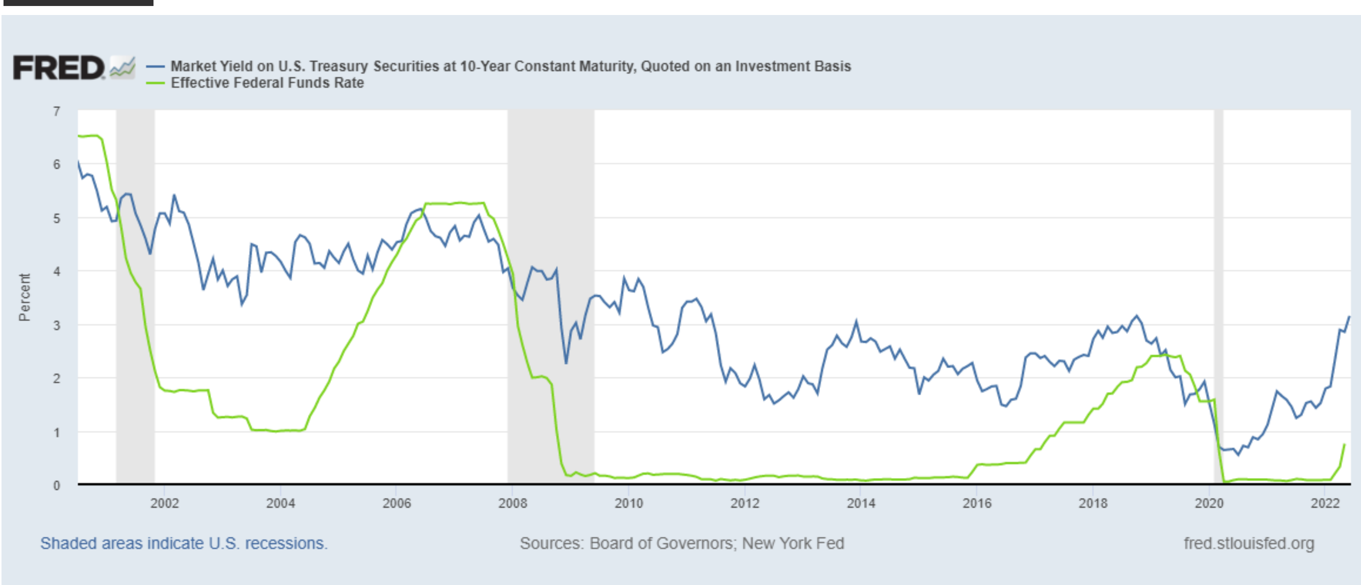
Are You Leaving Yield On the Table?

Why Premium Bonds May Make Sense

For years following the late-2000s financial crisis, the Federal Reserve maintained historically low Fed Funds rates. With rates at record lows, many would expect rates to eventually rise (Figure 1). This places pressure on the bond market, since rising rates lead to falling bond prices. In such an environment, bondholders are challenged to earn acceptable yields, without the added risk of excessive price volatility. They are naturally looking for any edge they can find.

In this type of market, paying premium for a bond is an attractive option, but one that few retail investors consider. Indeed, it seems counter-intuitive to pay more cash upfront than you will receive once the bond matures. Yet institutional investors often pay a premium, and it is important to consider why this may be a good choice for you as well.

FIGURE 1



What is a ***Premium Bond?***

First, a few definitions. The **par** (or face) value is the amount a bond pays out at maturity. A par bond sells exactly at its par value. For example, if a bond has a par or face value of $10,000, it will pay out $10,000 at maturity. If the market sets the selling price of that bond at $10,000, it is a par bond.

Bonds may also be purchased at either a **discount** or **premium** to the face value. In our example of a $10,000 par-value bond, if it sells for $9,500, it is a discount bond. If it sells for $12,000, it is a premium bond.

The **coupon** refers to the interest paid to the bondholder, typically annually or semi-annually. Again, using the example of a $10,000 par-value bond, if it has a fixed coupon rate of 2.00%, the bondholder will receive $200 in interest payments each year.

The **yield to maturity (YTM)** is a measure of the total return an investor receives over the course of a bond's life, and accounts for factors including the coupon, selling price, and par (redemption) value. If a bond is callable, meaning the issuer has the right to buy the bond back early on a predefined date or dates at a predefined price, the effective yield may be lower, which is known as a bond's **yield to worst (YTW)**. Since YTW uses the callable date rather than years until maturity in its calculation, it is always less than YTM and should always be considered when purchasing bonds.

Another important concept is **duration**, which is an estimate of interest rate sensitivity. Using duration, investors can compare the relative sensitivity of two bonds with different prices, par values, and coupon rates. A lower duration typically indicates the bond is less sensitive to fluctuations in market interest rates.

Why Would Anyone Pay ***Premium?***

Investors pay a premium, or more than face value, in exchange for receiving higher interest payments over the life of a bond. Although the investor will ultimately receive less than their initial investment at redemption, the premium bond's above-market coupon allows it to earn a higher overall yield than on a comparable discount or par value bond. This illustrates why, under certain circumstances, it may make sense to pay more up front. While some buyers shy away from the premium bond market, shrewd investors recognize there are opportunities to be had.

For investors whose primary investment goal is income, premium bonds produce higher cash flows over the life of the bond, due to their higher coupon rates. These larger cash flows allow the investor to recoup their investment more quickly, and to benefit from an above-market rate fixed income stream until the bond sells or matures.

One of the most underappreciated features of premium bonds is their lower duration, which results in lower price volatility and interest rate risk than comparable discount or par bonds. This concept is illustrated in the example shown in Figure 2.

FIGURE 2

Bond Type	Discount	Par	Premium
Issue Date	1/1/2020	1/1/2020	1/1/2020
Maturity Date	1/1/2030	1/1/2030	1/1/2030
Face Value	$10,000.00	$10,000.00	$10,000.00
Coupon Rate	2.00%	2.50%	5.00%
Yield to Maturity	2.57%	2.50%	2.69%
Price	$95.00	$100.00	$120.00
Price Paid	$9,500.00	$10,000.00	$12,000.00
Annual Interest	$200.00	$250.00	$500.00
Duration	9.14	8.97	8.30
Assuming the investor purchases 10,000 notional on the issue date:			
Summation of Flows over 10 years	$2,000	$2,500	$5,000
Premium Gain/ Loss	$500	$0	($2,000)
Total New Flows	$2,500	$2,500	$3,000

As you can see in this example, despite the higher price paid initially for the premium bond, the yield to maturity is higher, and duration is lower than both the discount and par bonds.

Some Words of *Caution*

Buying a premium bond generally makes the most sense when rates are low and rising, because premium bonds offer greater pricing stability in a rising rate environment. Because of their lower duration, premium bonds tend to hold their value better than discount or par-value bonds when rates are on the upswing.

That said, investors considering purchasing a premium bond must fully consider the risks before entering such a transaction. Educate yourself on the following aspects:

! ***Callable bonds.*** Some bonds have a call option, meaning the issuer can redeem the bond prior to maturity. Callable premium bonds are much more likely to be called in a rising rate environment, as the issuer would rather pay off the bond and issue a new, lower-coupon bond than continue making interest payments at above-market rates. Callable bonds generally offer higher yields to offset the additional risk. Yield to call (YTC) is an important measure to consider, as it presents the worst-case scenario for investors if their premium bond is redeemed at the earliest possible call date.

! ***Credit risk.*** Credit risk is an important factor in all bond transactions. Before making a purchase, determine if the investor is comfortable with the risk/return profile of the bond, based on its rating by a leading bond rating agency such as Moody's and Standard & Poor's (S&P). Municipal, U.S. Government, and corporate bonds have historically been relatively safer bets, but the values of even these conservative investments do fluctuate over time based on perceived changes in credit-worthiness.

! ***Interest rate risk.*** Investors must also consider where rates are headed over the life of the bond. Premium bonds tend to perform better in a rising rate environment but underperform comparable discount and par bonds when rates are dropping. Discount bonds are often a better option in those markets. In addition, as rates fall, a premium bond's higher cash flows become a detriment, as the cash received can only be re-invested into lower-yielding investments.

! ***Tax implications.*** Accounting for the tax impacts associated with the purchase, sale, and cash flows of any bond can be complicated. For premium bonds, calculating a cost basis for tax purposes adds an additional wrinkle. In addition, a bond may be taxable or tax-exempt. If tax-exempt, the investor has limited options for how to treat the amortization of coupon payments. Be sure to consult with your trusted tax professional to fully understand all the tax ramifications specific to your situation.

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