Bond Basics: Why the Premium?

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A premium bond is one which market value is greater than its face value. To understand why a bond trades above its par value – at a premium – it is helpful to review the relationship between interest rates and the price of a bond. As yields change in the marketplace, the only variable which can change to compensate an investor for the required yield in the marketplace at present is the price of the bond. In other words, the market will adjust bond prices so that yields on otherwise similar bonds with different coupon rates will be roughly equal.

When the required yield in the market increase above the coupon rate on a bond, the price of that bond must adjust so that investors can realize additional yield. If the price did not adjust, investors would not purchase the bond because it offers a yield which is below the yield they can obtain from a newly issued bond in the market. On the other hand, when prevailing interest rates decline, bonds which were issued during a higher interest rate environment become more valuable due to their higher stated coupons. Due to this coupon rate being higher than what is currently being issued in the market the price of the bond increases to a price where the bond offers the same yield as that currently required in the market.

With interest rates currently near record low levels many bonds are trading at a premium. But investors often shy away from premium bond because they know that the value of their premium bond will have to decline towards par as the maturity date approaches. This means the return of the bond (price appreciation/depreciation + income return) will not equal the coupon rate of the bond, as it would have if the bond was purchased at par ($100).

However, there are several advantages to purchasing a bond trading at a premium including:

1) **Higher coupons:** The premium paid for the bond will be recouped through the investor receiving higher coupon payments over the life of the bond.
2) **Lower duration:** A premium bond has a lower duration due to its higher coupon, meaning its total return will suffer less for a given increase in interest rates compared to the return of a bond trading at or below par. For an instantaneous move higher in interest rates, the price of the premium bond will decline less for a given rise in interest rates than that of a par or discount bond. For changes over a

longer period of time, the erosion in the premium will decrease the price of the premium bond, but the extra income received from the coupon payments will still enable the premium bond to outperform. Due to this defensive characteristic, premium bonds are often known as 'cushion bonds'. However, the opposite will be true when interest rates decrease as the price of a premium bond will increase less quickly compared to a similar par or discount bond.

3) **Reinvestment during a rising interest rate environment:** The higher coupon of a premium bond will return more investable cash to the investor sooner which can be reinvested into new higher yielding issues.
4) **Premium bonds may be undervalued:** Many investors will not consider premium bonds because of a common misconception that a premium represents an overpayment on the bond. For this reason, premium bonds typically offer a higher yield to maturity than par bonds or similar quality and maturity.

For municipal bonds there are two additional reasons to consider the purchase of premium bonds:

1) **The possibility that the issuer will pre-refund the bond:** With interest rates declining many municipalities have used the low interest rates environment to refinance much of their debt at a lower interest rate – similar to how many homeowners have refinanced their mortgage payments. In the case of a municipality, a pre-refunding involves issuing a new bond at the present, lower, market rates and using the proceeds to pay down, or defease, the existing higher-rate debt. To defease the bond, the issuer will use the proceeds of the new bond to purchase US Treasury securities which will be held in escrow. They will then use the proceeds to retire the debt at the next call date. The credit rating of this issue will normally increase since the US Treasury is viewed as a risk free asset and the money is being held in escrow as a way to pre-fund the outstanding bonds. Depending on the call date the price of these bonds can actually rise due to the improvement in credit quality from the pre-refunding.
2) **De minimis tax penalty:** When the price of a bond drops below a certain threshold, known as the 'de minimis' threshold, the bond may become subject to taxation. A bond purchase at a price below the threshold will potentially be subject to ordinary income taxation of the accrual from the discounted purchase price to the par value of the bond. The tax liability falls upon the investor who buys the bond at a market discount, not upon the person who holds a bond that slips into market discount territory. However, the owner of the bond suffers because when selling discount bonds, investors may receive a lower price due to the tax implications the buyer will face if the bond is purchased below the 'de minimis' threshold. Since premium bonds are less likely to fall into market discount price than discount bonds are, investors do not need to be as concerned about the possible tax-related drop in price. Although the same tax treatment applies to taxable bonds, the market reaction is much smaller, since individual investors are a smaller part of the taxable market.