

# Premium Bonds 101

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Premium bonds and the math behind them continue to frown the brows of many municipal investors. A premium bond is one that sells at a higher price than its par value (typically \$100), or principal. It is a legitimate mind-bender for investors, as it would seem counterintuitive to intentionally purchase a bond at say, \$108.50, knowing that you will receive less than that (\$100) at maturity.

However, it turns out that premium coupons have some potential advantages. They can be more defensive in a rising interest rate environment and potentially less volatile. Additionally, they are generally more liquid than discount municipal bonds because premiums are typically the preferred and more-prevalent coupon structure in the municipal bond market.

To understand these advantages, investors must first grasp an important concept: bondholders do not lose the premium paid on a premium bond. If an investor buys a bond at \$108.50 that matures at \$100, they would not lose that extra \$8.50; instead, that amount would be returned to them over the life of the bond in the form of higher coupon payments.

Table 1 shows the mechanics of the cash flows of a premium bond. With premium bonds, the coupon rate is higher than the yield to maturity (YTM). This is because each coupon payment comprises not only the YTM (Column A), but also the return of a portion of the premium to the bondholder (Column B). (By contrast, for discount bonds the coupon rate is lower than the YTM). Premium bondholders do not experience a capital gain or loss if they hold the bond until maturity.

**FIGURE 1: HYPOTHETICAL INCOME FROM A 10-YEAR PREMIUM BOND**

Year	Interest Payment (YTM) (A)	Amortization of Premium (B)	Total Coupon Payment (A+B)	Carrying Value
0				\$108.50
1	\$4.29	\$0.71	\$5.00	\$107.79
2	\$4.26	\$0.74	\$5.00	\$107.05
3	\$4.23	\$0.77	\$5.00	\$106.29
4	\$4.20	\$0.80	\$5.00	\$105.49
5	\$4.17	\$0.83	\$5.00	\$104.66
6	\$4.14	\$0.86	\$5.00	\$103.80
7	\$4.10	\$0.90	\$5.00	\$102.90
8	\$4.07	\$0.93	\$5.00	\$101.97
9	\$4.03	\$0.97	\$5.00	\$101.01
10	\$3.99	\$1.01	\$5.00	\$0.00
Total	\$41.50	\$8.50	\$150.00	

Municipal Bond Price: \$108.50  
 YTM (Prevailing Interest Rate): 3.95%  
 Coupon Rate: 5%

For Illustrative Purposes Only. Results are based on a hypothetical bond. Actual results will differ.

Knowing this, investors can be open to capitalizing on the structural advantages offered by premium bonds over par/discount bonds, which include:

## Potentially Less-Troublesome Taxation<sup>1</sup>

According to IRS rules, investors purchasing bonds at a market discount must pay ordinary income tax on some portion of the discount. In this way, discount bondholders own bonds in which a portion of the return is taxable, and a portion is tax-exempt. Discount bonds not only require a tax outlay, but in our experience, they are also more difficult for investors to understand and value.

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It is important to remember that federal and local tax laws and rates can change at any time; changes to tax laws and rates can impact tax consequences for investors. Investors should consult with their tax professionals regarding tax management strategies and associated consequences.

## Liquidity

Due to the tax implications and complexity of discount bonds, they are generally less liquid than premium bonds. As of September 30, 2022, 5 percent coupons were the most prevalent in the municipal market, making them more liquid. On the other hand, par bonds are typically only available when a bond is first issued.

## Shorter Duration

Discount bonds typically have lower coupons and longer durations because more of an investor's principal is earned at maturity. Premium bonds have a shorter duration than par/discount bonds because they allow investors to build income faster, so the shorter duration offered by premium bonds can improve total return if rates go up – an important consideration as the U.S. Federal Reserve has continued its aggressive series of interest rate hikes. The higher income generated by increased coupon payments could help offset some of the price declines as rates rise. Also, with higher coupon payments, investors are able to reinvest the funds and take advantage of higher rates.

## Availability Of Tax Loss Swaps

Tax loss swaps can help municipal investors by offsetting large taxable gains with losses on the municipal side.<sup>2</sup> Given the lower liquidity in municipal market, tax concerns and lower coupons of discount bonds, rate normalization could be particularly detrimental to them. If rates rise, the loss on a par/discount bond may be too large for a tax loss swap to work. This could negatively impact investors with heavy tax burdens, because it makes the swap more difficult and costly to execute.

The immediate takeaway is that discount bonds are potentially harder to sell, as sellers must offer several layers of discounts to entice investors to purchase them. The first layer is the market discount embedded in the bond itself. The second layer is the present value of the future tax liability discussed above. This is less of an issue for longer-term bonds in which this liability is spread out over longer time periods. But for intermediate-term bonds, this can make a significant difference in where the bond can be sold. The third layer is an amount to compensate investors for the lower liquidity of par/discount bonds. Premium bonds are not subject to these layers of discounting, and offer certain structural benefits in a rising rate environment.

We think premium bonds offer value in many interest rate environments. They can offer a defensive position when rates rise. Because they historically have retained their value more so than discount bonds, they have been more liquid than discount bonds.

## A Word About Risks

Investors should be mindful that all investing involves risk, and that principal loss is possible. Investing in municipal bonds, regardless of whether they are discount or premium bonds, involves interest rate risk, credit risk and market risk. In addition, income from municipal bonds can be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the IRS or state tax authorities, or noncompliant conduct of a bond issuer.

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FOOTNOTES:

1. Federal and local tax laws can change at any time. Changes can impact tax consequences for investors; consulting a tax professional before making any decisions is strongly recommended.
2. In a tax loss swap, an investor will sell a bond for a loss and replace it with another bond with a similar maturity or credit profile. Due to differences in tax rates, swaps may not be appropriate for certain individuals and the results of swaps do not guarantee a profit or significant tax advantage.

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