Municipal Insights

Why invest in tax-exempt premium bonds?

A premium bond is a fixed income security that sells for more than the bond's par value or face value, which is the amount to be paid to the holder at maturity (usually $1,000 per bond).

It can be difficult to see the benefit in paying more than par value for a bond, but investors should recognize that premium bonds offer a variety of potential advantages, including larger cash flows, better liquidity, lower volatility, and, in a rising interest rate environment, protection from the De Minimis Tax Rule.[1] Additionally, most bonds issued over the past several years have been sold well above par due to the very low interest rate environment, as well as demand from institutional bond managers for the premium structure. As such, selection of par and discount bonds has been extremely limited.

Measuring a bond's value

Why do bonds sell at a premium? It's a function of the coupon the bond pays and the prevailing interest rate for that maturity. In general, if the bond's coupon is higher than the purchase yield, the price will be at a premium. Likewise, if the coupon is less than the yield, the price will be at a discount. And, as we see at times on new bond deals, if the bond's coupon is the same as the purchase yield, the price will be at "par," or $1,000.

Investors avoiding premium bonds will not only be limiting the potential universe of bonds that can be purchased in either the primary or secondary markets, but may be giving up important potential advantages, particularly if they are concerned about interest rates increasing in the future. Specifically:

- Premium bonds offer higher cash flows from coupon payments (and thus, more tax-exempt income)
- Premium bonds have lower durations and less price volatility
- Premium bonds typically perform better in a rising rate environment
- Premium bonds are currently more plentiful and offer greater liquidity
- Premium bonds offer more protection against "falling out of de minimis"

[1] **De Minimis Tax Rule** is a rule that stipulates the level at which a discount on a bond will be taxed at the capital gains tax rate or the ordinary income tax rate of the buyer. If a bond is purchased with a discount less than a quarter point per year between the time of acquisition and maturity, the gain is subject to the capital gain tax rate. If the discount is larger than prescribed, the bond has "fallen out of de minimis" and the discount is subject to the investor's ordinary income tax rate. When you buy a par or discount coupon bond and interest rates rise (bond prices fall) by a substantial amount, you may find yourself holding a bond that has a discount subject to ordinary income tax. As was the case at purchase, the coupon is still exempt from federal income tax. Please consult your tax professional for more information.

Municipal fixed income

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Enhanced cash flows

It is important for the investor to remember that purchasing a premium bond does not mean the investor is being over-charged, but merely buying a bond with a coupon above the prevailing market rate. You are paying a premium for higher future cash flows relative to a par or discount bond. The premium paid on the tax-exempt bond (plus interest earned on that premium) is amortized over the life of the bond and returned to the investor in the form of higher coupon payments (i.e., greater overall income). Likewise, purchasing a discount bond does not mean the investor is "getting a deal"; the investor is merely purchasing a bond with a coupon below the market interest rate. At maturity, both bonds will pay the investor par plus the coupon interest determined when the bonds were sold to investors. Figure 1 below provides an example of the cash flows for a 3% coupon, 10-year non-callable par bond vs. a 5% coupon, 10-year non-callable premium bond.

Figure 1

Features	Premium bond	Par bond
10-year maturity, non-callable		
Annual coupon	5.00%	3.00%
Yield to maturity	3.00%	3.00%
Price per 100 bonds	$117.17	$100.00
Par value of bonds purchased	$100,000	$100,000
Initial cost	$117,169	$100,000
Total tax-exempt income over 10 years	$50,000	$30,000
Par returned	$100,000	$100,000

For illustration purposes only. Over the life of the bonds, the premium must be amortized. Assumes coupons not reinvested. Incremental cash flow of $2,831 for the Premium Bond structure is due to the higher upfront cost of the Premium Bond and the resulting interest earned on the bond premium and is amortized over the life of the bond. Consult your investment adviser and/or tax advisor for additional information.

Lower volatility in rising rate environment

The higher coupons of premium bonds are defensive in nature during a rising interest rate environment. As market rates rise and bond prices decline, the premium bond with its higher coupon will have larger periodic interest payments than par and discount bonds. It is this ability to reinvest a larger amount at higher rates sooner that helps minimize price volatility. On the other hand, premium bonds do not appreciate in price as quickly as par and discount bonds when interest rates are falling.

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Downside to imposing price restrictions on bond purchases

Over the past twenty years, many tax-exempt bonds have been sold bearing the 5% coupon structure regardless of interest rate environment during the offering. Even many municipal bonds with maturities shorter than ten years were issued with 4-5% coupons. With tax-exempt interest rates typically much lower than 4-5% over this period, most municipal bonds outstanding were issued at a premium to par. With current interest rates remaining below long-term averages, these 4-5% coupon bonds are still trading at premiums in the secondary market. To highlight this, we broke down the coupon exposure of the Bloomberg Barclays Municipal 1-10 Year Index as of 12/31/2018. We found that over 85% of the Index consists of tax-exempt bonds with coupons of 5% or greater (i.e., premium bonds). The point is, by imposing an artificial price limit on your municipal bond purchases, you are significantly narrowing your investable universe and your portfolio's total return potential.

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