Premium bonds

Wealth Management

The word premium is defined as “above the rest, superior, unusually high value.” In the world of fixed income, premium bonds take on investment characteristics that often make them more attractive than other fixed income instruments. Fully understanding the nuances of these bonds and how they can provide higher yields and higher cash flows is key in the current interest rate environment.

What are premium bonds?

Premium bonds are fixed income securities that sell at a level above their par value. At first glance, paying more than face value (or par) for a bond seems illogical; yet due to the underlying terms of the security, paying a premium can actually provide an enhanced return.

Bonds are issued with a stated par amount, usually $1,000, a coupon (or interest rate), and a stated maturity date. For most bonds, these will not typically change. One must remember, however, that as interest rates change, bond prices will move inversely. Due to the fixed nature of a bond’s coupon, the price of a bond adjusts to bring the bond’s yield in line with prevailing market interest rates. This can be more clearly viewed in the following example (as also demonstrated in the table on page 2).

Let’s assume that Bond A was issued a few years ago when interest rates were higher with a coupon rate of 4.30% and a par value of $100,000. Since then interest rates have declined and the company issues a new bond, Bond B, with similar characteristics to Bond A with a 2.00% coupon. Because fixed coupons never change, Bond A pays $4,300 annually while Bond B pays $2,000. Understandably, investors consider a bond that pays $4,300 more valuable than a similar bond that pays $2,000. Thus, investors are willing to pay a higher dollar price for Bond A than Bond B.

The premium advantage

There are two distinct advantages realized when investing in premium bonds:

- **Higher current cash flow** — Premium bonds are ideal for investors who want to maximize current income without having to sacrifice quality. The higher coupons attached to premium bonds offer a higher current income than similar current coupon or discount debt. This increased cash flow is usually more than the premium paid for the bond. This is the true value in premium bonds. See the example at the end of this piece for a more detailed analysis of how the numbers compare.
- **Higher yields** — Premium bonds will typically trade at a higher yield than bonds priced at par or below because investors are reluctant to pay more than the stated par amount. Thus, the investor who understands the value of premium bonds can take advantage of this market pricing inefficiency, and receive above market yields.

Tax considerations

The tax treatment for securities purchased at a premium varies depending on the taxable or tax-exempt basis of the bonds.

- **Taxable securities** — For most investors, any premium paid on a taxable bond can be partially recovered through your income tax filing, if the bond is held to maturity. The premium on a taxable bond can be either amortized over the remaining life of the bond or taken as a capital loss at maturity. When an investor elects either treatment, all bonds held by the investor must be treated the same.
- **Tax-exempt (municipal) securities** — Premiums paid on tax-exempt municipal bonds must be amortized over the life of the bond either to maturity or, if pre-refunded, the refunding date. The bondholder’s cost basis can be adjusted to reflect the amortization but may not offset any interest income claimed on the tax return.

We advise our clients to seek professional tax advice for more details on the different amortization and accretion methods and how they may affect a security's cost basis.

Conclusion

Premium bonds are a core element of fixed income investing. They offer investors higher current income and yields when compared to other types of bonds and, in many cases, provide greater price stability. The premium advantage should play an important role in your fixed income portfolio.

For further information on premium bonds, call your RBC Wealth Management financial advisor.

Following is an analysis that demonstrates how the premium bond with a higher coupon cash flow will offset the premium paid for the bond and provide enhanced value.

The premium advantage – corporate bonds (as of 12/19/2014) An investment example of the additional income that can be found in premium bonds			
Premium bond		Par bond	
ABC Corp 4.30% due 10/15/2040		ABC Corp 2.00% due 6/15/2035	
Priced at $115.985		Priced at $100.00	
2.12% yield to maturity		2.00% yield to maturity	
Total income ($4,300 x 10 years)	$43,000	Total income ($2,000 x 10 years)	$20,000
Principal at maturity	$100,000	Principal at maturity	$100,000
Total of above	**$143,000**	**Total of above**	**$120,000**
Purchase amount	$115,985	Purchase amount	$100,000
Net	**$27,015**	**Net**	**$20,000**
The premium advantage: $7,015 more income (or 35% more)			

For illustrative purposes only

Bond investors should carefully consider risks such as interest rate risk, credit risk and market risk, including the possible loss of principal.