# Premium Bonds: What Might Investors Be Missing?

Investors focused only on a bond's dollar price may be missing out on opportunities for attractive income in higher coupon bonds.

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**Table 1. Price Points: Attributes of Three Hypothetical Bonds Trading Above, At, and Below Par**

While the prices differ, the yields are identical

Premium bonds offer higher cash flow than similar, lower-priced bonds

Higher-coupon bonds are less sensitive to changes in interest rates relative to similar bonds

| Price | Yield to Maturity | Years to Maturity | Coupon | Duration | Price Impact of +1% Change in Yield |
|---|---|---|---|---|---|
| 87 | 3.00% | 10 | 1.50% | 9.1 | -8.68% |
| 100 | 3.00% | 10 | 3.00% | 8.6 | -8.18% |
| 117 | 3.00% | 10 | 5.00% | 8.1 | -7.68% |

Source: Lord Abbett. This hypothetical example is for illustrative purposes only and does not represent any specific account managed by Lord Abbett or any particular investment.

**In Brief**

- Information on a bond's price alone is insufficient in determining its relative attractiveness.
- Premium bonds offer a higher cash flow than similar at-par or discount-to-par bonds.
- Also, premium bonds with higher coupons may be less sensitive to changes in interest rates than similar bonds with lower coupons, and thus lower prices.

Individual investors in the municipal bond market have often expressed reluctance to purchase bonds trading at a price above par value. With that in mind, we address five important considerations for those investors who might still be wary of premium bonds:

### 1. For bonds, we believe it's better to analyze the yield, not the price.

While many retail investors tend to focus on a bond's price, portfolio managers are more inclined to consider a mosaic of data including coupon, time to maturity, duration, credit spread, and most important, yield to maturity, when determining the relative attractiveness of a bond. Table 1 shows how all those factors come into play.

It's important for investors to realize that a bond's yield to maturity (YTM) represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity.[1] YTM is a useful, standardized barometer that can help investors compare their investment options. What makes it more informative than looking at price alone is that yield to maturity considers both the time value of money *and the bond's current price*. Taking all this into account, Table 1 demonstrates that three hypothetical bonds with the same credit rating and time to maturity can have different prices (i.e. discount to par, par, or premium to par) and yet have the same yield to maturity. The dollar price is simply a function of the size of the coupon.

Given the choice between the three, an individual investor following the simplistic, but logical mantra "buy low, sell high," may choose the discount bond, with the rationale being, "I have the opportunity to receive price appreciation from discount to par." While this is true (assuming the bond doesn't default), the price of 87 is already factored into the yield to maturity calculation, and thus the investor's return; if the bond is held to maturity, it should be similar to that of the bond priced at 117, given that it shares the same YTM.

However, the source of that return would differ. The discount bond would see more return come from price appreciation, while the premium bond would generate more return from current income.

### 2. Premium bonds may provide higher cash flow...

Similar bonds (i.e. similar credit risk, liquidity risk, time to maturity and yield to maturity) will trade at different dollar prices based on the size of their coupon. Recognizing that a bond's price is the present value of its future cash flows, a higher coupon should logically translate to a higher dollar price. Given that tax-free income is one of the benefits that municipal bonds offer, the higher tax-free cash flow from higher coupon bonds may be attractive to many investors.

### 3. ... and they also may offer lower duration ...

Since higher coupon bonds provide a higher cash flow relative to similar, lower coupon bonds, higher-coupon bonds generally have a lower duration, and thus exhibit lower sensitivity to changes in interest rates. In the example illustrated in Table 1, the hypothetical discount bond has a full one-year longer effective duration when compared to the premium bond of the same quality, maturity, and yield to maturity.

### 4. ... while still having the potential for price appreciation.

There may be a general misconception among some investors that bonds trading above par have only one path to follow in terms of price, that is, down towards par. While a bond's price will ultimately amortize back towards par value at maturity, its price can fluctuate down or up between the time of purchase and maturity. If price appreciation did occur, it might be the result of an upgrade in credit quality, a change in interest rates, or from the effects of what is known as a yield curve roll down.

For example, a bond trading with a coupon that is higher than the prevailing market rate for such a bond will be trading at a premium. Given an upward sloping yield curve, as time passes and the bond's time to maturity shortens, the prevailing market rate will continue to decline, while the bond's coupon will remain constant, further increasing the spread between coupon and market yields. The bond's yield must adjust (decline) to align with prevailing market yields, and thus its price must adjust higher. From another perspective, investors would likely pay a premium for a bond with a coupon that is above market rates. This higher cash outlay lowers the yield to that of market yields.

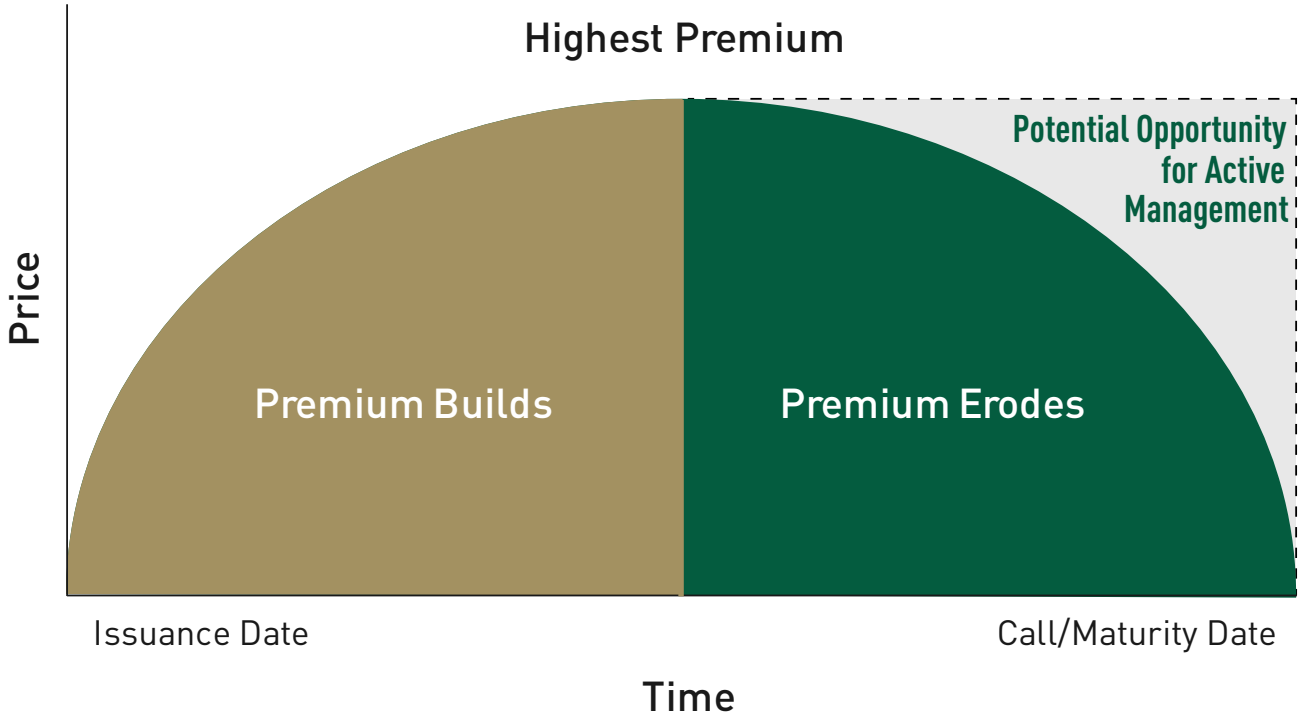
Since a bond's price represents the present value of its future cash flows, as the bond approaches maturity, the number of expected coupon payments falls low enough to cause the bond's price to decline to par. However, the bond's yield at the time of initial purchase has already taken into account this amortization to par value; therefore, this decline in price shouldn't be viewed as a "loss," because it isn't one.

Thus far, for the purposes of this discussion, we have made the assumption that bonds will always be held to maturity. Active managers, however, can seek to capitalize on the effects of bond's "rolling down the yield curve" as time passes and bonds progress toward their maturity dates (see Chart 1). Portfolio managers might maximize price appreciation potential by investing in bonds on the steepest parts of the yield curve and subsequently selling those bonds to capture the highest premium; they may then reinvest the proceeds in other bonds in a similar fashion.

### 5. For municipal bond investors, premium bonds may offer tax and liquidity benefits.

There is another consideration specific to municipal bonds that investors need to know. If a tax-free bond's price trades below a certain discount threshold, the buyer is required to pay ordinary income tax (versus capital gains) on any price appreciation due to the "de *minimus* rule." Discount and par bonds are more likely to be subject to this rule than bonds trading at a premium to par value. In fact, the discount bond may actually trade down even further; boosting its yield, in order to compensate investors for this tax liability and offer a comparable after-tax yield to maturity relative to other bonds in the market. Therefore premium bonds may offer investors better price stability, as well as liquidity, while avoiding this potential additional tax burden.

**Chart 1. How Active Strategies Might Capitalize on Changes in Bond Premiums**




Source: Lord Abbett. Chart depicts a theoretical scenario of changes to a bond's price over time, assuming an upward sloping yield curve. **Past performance is not a reliable indicator or guarantee of future results.** For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

### Summing Up

There may be certain circumstances when a lower dollar priced bond is more desirable. For example, in the case of a corporate restructuring, bondholders of an issuer with similar priority claims get treated equally in a recovery scenario. In that situation, a lower purchase price would result in the potential for a lower loss in the case of a default. Such restructurings, however, have been quite rare among investment grade municipal bonds.

There are numerous factors that can affect performance in the fixed-income markets. A disciplined approach to fixed-income investing involves a detailed analysis that not only accounts for the price of a bond but also includes yield to maturity, coupon, and duration, among other factors. While we would not suggest that premium bonds always present the best opportunity, a single-minded focus on the price of a fixed-income security at the expense of those other considerations may deprive investors of the chance to participate in the potential for attractive tax-free income and return offered by some premium bonds.

[1]While yield to maturity is an important factor for non-callable bonds, yield to worst should be considered for callable bonds.

**A Note about Risk:** The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state and local taxes may apply. Investments in Puerto Rico and other U.S. territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems. No investing strategy can overcome all market volatility or guarantee future results. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

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**Coupon** is the interest rate on a bond that is expressed at the bond's face value, or par.

**Duration** is a measure of the sensitivity of a bond's price to changes in interest rates.

**Maturity** is a bond's term. When it matures, the bond holder will receive its principal and final interest payment.

**Par** is the face value of a bond, usually $1,000, which is returned to bond investors at maturity.

**Price** refers to the price of a bond, which is expressed as a percentage of par. Most bonds are issued in increments of $1,000.

The **time value of money** is the concept that money available at the present time is worth more than the identical sum in the future.

A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

**Yield curve roll down** is an investment strategy for maturing bonds which potentially allows investors to capitalize on a bond's falling yield, and rising price, as it nears maturity.

**Yield to maturity** is the potential rate of return on a fixed-income instrument if it is held until maturity. The yield-to-maturity calculation referenced also assumes that all coupons are reinvested at the prevailing market yield.

**Yield to worst** is the lowest yield that can be paid on a bond, assuming the issuer does not default. The calculation takes into consideration worst-case scenarios in which the bond would be paid prior to maturity. It is assumed the bond will be prepaid if current interest rates are lower than the current coupon rate.

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