Premium bonds

A higher-income option for your portfolio

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Bond prices tend to move in the opposite direction of interest rates. So, as interest rates change, bonds can be priced at par value, at a discount to par value or at a premium to par value. If your portfolio includes premium bonds, it may generate more income.

The price is right

Generally, individual bonds are issued near face (or par) value, or $1,000, which is also the amount returned to the bondholder at maturity. However, between the issue and maturity dates, a bond's price can fluctuate. When a bond is selling at a price below par value (such as $950), it's said to be selling at a discount. Should it sell at a price above par (such as $1,040), it's called a premium bond.

Bond price fluctuations are primarily due to changes in three factors:

- Interest rates
- The bond's credit quality
- The length of time until the bond's maturity (which continually shrinks)

Interest rate changes are generally the most important driver affecting bond prices, because rates can shift significantly in a relatively short time. Because most bonds' coupon rates (agreed-upon interest rates) and maturity dates are fixed, their prices are the only components that are free to react to interest rate changes. With interest rates fluctuating frequently, it is common for bonds to trade at a discount or at a premium to par value over their lives.

Imagine, for example, that you paid $1,000 for a 10-year, noncallable bond with a coupon rate of 4%. If interest rates rose to 5%, it would be impossible to find a buyer willing to pay $1,000 for your 4% bond when similar bonds paying 5% are readily available.

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If you needed to sell your bond, you'd be forced to discount its price to the point where it could provide a rate of 5% to the buyer. In this case, you could sell your bond for about $922. On the other hand, if rates fell to 3%, your 4% bond would price at a premium to give a rate of 3%, or about $1,086.

As interest rates go up, bond prices go down, and vice versa. In other words, there's an inverse relationship between changes in interest rates and bond prices. Therefore, if you choose to sell a bond prior to its maturity, the price you receive may be more or less than your original investment.

Three advantages to paying a premium price

1. Higher coupon rates

Higher coupon rates are a benefit for paying a premium price for a bond if you hold your bond to maturity. For example, if current rates for bonds priced at par value are 4%, rates for premium bonds could be 4.1% or more.

2. More income

If you're a serious, long-term investor whose primary consideration is income, premium bonds may be attractive to you because they can provide higher cash flows over the life of the bond.

The chart below shows that premium bonds provide you with more income over the life of the bond, even though you pay that premium price upfront.

Hypothetical comparison: Par vs. premium bond

	Par bond*	Premium bond**
Original cost	$10,000	$10,818
Principal returned	$10,000	$10,000
Difference	$0	-$818
Annual interest, years 1-10	$400	$500
Total interest	$4,000	$5,000
Principal loss	$0	-$818
Net cash flow	$4,000	$4,182
Additional cash flow		**$182**

* Par bond: 4% coupon due in 10 years. Noncallable. Price = 100. Yield to maturity (YTM): 4%.

** Premium bond: 5% coupon due in 10 years. Noncallable. Price = 108.18. YTM: 4%.

Source: Edward Jones. Figures do not account for taxes or transaction fees.

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3. Better price stability

Sometimes the best offense is a good defense. In addition to the income advantage they offer, premium bonds can provide a good defense against interest rate fluctuations and price changes. The sooner investors receive cash flows (interest and principal payments) from their bonds, the smaller the impact of interest rate changes on bond prices.

Premium bonds pay a greater proportion of their cash flows prior to maturity because interest payments are higher. Consequently, their prices tend to be more stable than those of discounted or par bonds. Should interest rates rise, the price of premium bonds would not decrease as much as those of discount or par bonds. Conversely, if rates fall, premium bond prices would not increase to the same degree.

Check on call protection

When purchasing premium bonds, it's important to know whether they can be redeemed or called prior to maturity. If interest rates fall, there's a greater likelihood that premium bonds will be called, which could result in reinvestment risk — that is, the risk that your income may decline after you reinvest your principal.

While you can (and should) be compensated for taking on the additional risk of a bond called prior to maturity, it's best that the bonds have at least some call protection. Ask your Edward Jones financial advisor about this feature. Call protection helps ensure your income has a higher degree of stability — and it can help you avoid an early and unexpected call, which could result in a loss of principal.

Put premium in your portfolio

Premium bonds frequently offer good values and can be an attractive alternative to discount and par bonds. They can be appropriate for you if you're looking for higher income or concerned about price stability, provided call provisions are considered and part of a well-diversified portfolio.

Your portfolio should be composed of different investments designed to work together to help you meet your long-term financial goals. In addition, you should understand how various fixed-income risks — including market risk, credit risk and interest rate risk — can impact your portfolio and how the diversification and quality of your investments can help mitigate that impact.

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