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2 | Why would I pay more than face value for a bond?

We frequently hear the question - Why should I pay more than face value for a bond? Keep reading to find out why it may be a good idea especially as rates move higher.

The idea of paying "more" or a "premium" for a bond at time of purchase and receiving less than that purchase price at maturity is a sensitivity most investors struggle to overcome. While an investor might think they are surrendering wealth, mathematically the total cash flows are the same as a similarly yielding par bond bought at the same time. The notion of loss is just a perception as the table below illustrates the cash flow equality.

There are three mathematical components for a bond - face value (par or maturity value), coupon (the rate of cash income paid by the bond), and maturity date. When an investor buys a bond, it may be priced at par, at a premium, or at a discount to face value.

Buying a premium bond means an investor makes a larger initial investment, $12,350 in the table below, and in exchange receives periodic Coupon payments (cash income) that are greater than market interest rates on purchase date.

Both bonds in the table yield 2.65% (hypothetical market interest rate) but the premium bond investor receives Coupon payments each year greater than the par bond investor – 5.00% on the premium bond = $500 versus 2.65% on the par bond = $265. The higher Coupon payments conceptually provide a partial return of the higher purchase price.

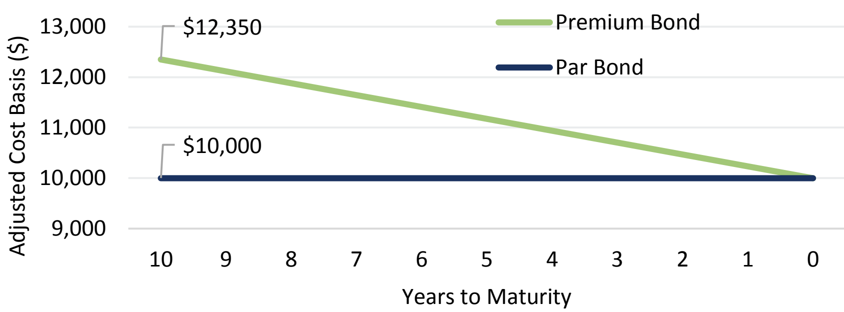
"Why pay more for the same yield?" Cash Flow. The greater annual cash flow from the premium bond Coupon payments provides funds for investors to reinvest at higher rates during a period of rising market rates. As fixed income investors are currently seeing rates rise, capturing those higher yields with Coupon reinvestments is an important contributor to building higher portfolio income.

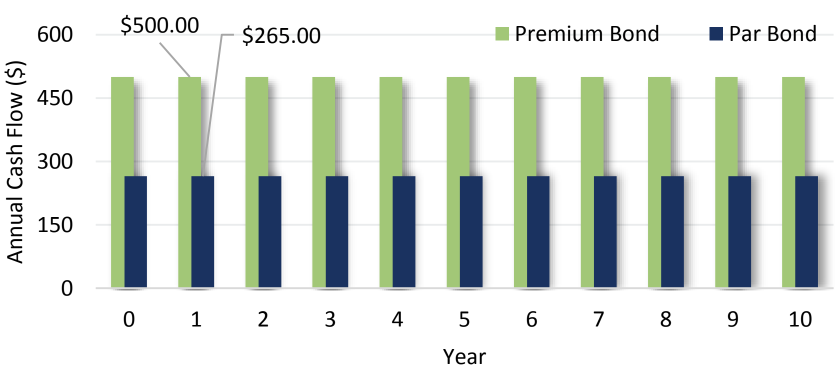
In the meantime, the market values of premium bonds are less sensitive in a rising interest rate environment than those of bonds bought at par or at discount because of the value placed on reinvesting those Coupon payments sooner rather than later. As markets are transitioning from a period of very low interest rates, this reduction in price sensitivity helps dampen changes in portfolio value and may be of comfort to investors.

It should be noted that the outlook for interest rates and expected market values must be considered when evaluating the purchase of a premium bond. For example, if market interest rates fall, lower coupon bonds (prices closer to par or at a discount) would tend to perform better than higher coupon bonds because lower coupons translate into slower reinvestment of cash flows when rates are expected to be low.

Each investor must identify and be cognizant of all risks involved with investments. Having access to the full range of bonds in the marketplace and the respective nuances is not something an individual investor should expect from a website or online resource. Caprin's experienced team of portfolio managers has that access to the full spectrum of national bond offerings and carefully assesses investment risks and special circumstances such as premium bonds.

Professional money managers like Caprin can relieve the individual investor of the complexities of fixed income investing and can responsibly position the investor's wealth for the future of interest rates.





Example of Pricing for a $10,000 Bond Purchase*

Type of Bond**	Maturity Date (10 yrs)	Coupon (%)	Yield to Maturity (%)	Price ($)	Initial Investment ($)	Annual Interest ($)	Total Over Holding Period = Maturity Value + Coupon Payments – Premium ($)
Par	2028	2.65	2.65	100.0	10,000	265	10,000 + 2,650 - 0 = 12,650
Premium	2028	5.00	2.65	123.5	12,350	500	10,000 + 5,000 - 2,350 = 12,650

* Illustrative calculation assumes no accrued interest paid at purchase of either bond.
**Bonds shown offer same yield at time of purchase and assumes no default and the bond is held to maturity.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this piece, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion of information contained in this piece serves as the receipt of, or as a substitute for, personalized advice from Caprin Asset Management. To the extent that a reader has any questions regarding the applicability to their situation of any specific issue discussed herein, they are encouraged to consult with the professional advisor of their choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.