Key Questions

When are Premiums Better than Getting a Discount?

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When choosing between two items of equal value, the rational person buys the lower-priced item. But the opposite principle holds true for investors in the municipal bond market: Premiums are sought, and discounts are shunned.

Soon American consumers will begin lining up outside of retail stores for annual Black Friday sales, and all of those shoppers will be eagerly searching for purchases at deep discounts. When choosing between two items of equal value, the rational person buys the lower-priced item. But the opposite principle holds true for investors in the municipal bond market: Premiums are sought, and discounts are shunned. While there's nothing akin to a Black Friday event in this market niche, municipalities issue new bonds weekly, and market professionals line up regularly for the opportunity to buy higher-priced bonds.

A bond priced greater than 100 is known as a "premium bond" while a bond priced less than 100 is known as a "discount bond." If a bond's coupon exceeds its yield, it will trade at a premium to par (over 100). If its coupon is below its yield, it will trade at a discount to par (less than 100). All bonds mature at par, so a holder of a bond with a par or face value of $100,000 will receive $100,000 upon maturity, assuming the bond does not default.

Here's an example of two bonds that have the same maturity date and yield, but two different coupons that make one a premium bond and one a discount bond.

Price of Premium and Discount Bonds at Time of Purchase

Bond Type	Maturity	Coupon	Yield	Price
Premium	9/1/2029	5.00%	1.80%	$128.79
Discount	9/1/2029	1.75%	1.80%	$99.55

An investor can purchase the premium bond today for $128,790 and receive $5,000 in annual interest payments or s/he can purchase the discount bond for $99,550 and receive $1,750 in annual interest payments. Both bonds will return $100,000 at maturity and each yield 1.80%. So which is the more attractive investment?

Professional municipal bond managers will wait in line for the premium bond and not give the discount bond a second look. When interest rates go down, bond prices go up. When interest rates go up, bond prices go down. And when bond prices go down, they get closer to their market discount threshold for tax purposes.

According to IRS rules, all bonds have market discount threshold of 0.25% per year until maturity. That is, for bonds purchased at a discount of more than 0.25% for each full year from the time of purchase to maturity, gains resulting from the discount are taxed as ordinary income rather than capital gains.

For municipal bond investors in higher tax brackets, ordinary income rates will be significantly greater than capital gains. As a result, experienced investors seek premium municipal bonds to avoid this exposure.

For the 10-year bonds in this example, the market discount threshold is $97.50. A purchase of either bond below $97.50 would be subject to ordinary income tax on the difference between the purchase price and $97.50. If interest rates rose 0.5%, the price of each bond would go down, but the discount bond would now be below its market discount threshold.

Price of Premium and Discount Bonds After an Increase in Interest Rates of 0.50%				
Bond Type	Maturity	Coupon	Yield	Price
Premium	9/1/2029	5.00%	2.30%	$123.69
Discount	9/1/2029	1.75%	2.30%	$95.17

The price on the discount bond is now below $97.50, so tax would be due on the difference between $97.50 and $95.17. The market will factor in the tax due on the market discount and push the price even lower. Assuming the top marginal tax bracket, an after-tax yield of 2.30% would require purchasing the bond at $92.84. The increase in rates caused the price of the premium to decline 3.9%, while the price of the discount bond declined 7.1%.

Tax rates for municipal bond investors tend to be higher than those for corporate and government bond investors, making the tax paid on the market discount more impactful. The municipal bond market is sensitive to the risk of bonds falling below the market discount threshold. Premium bonds mitigate this risk, especially in a rising rate environment. As a result, premium bonds are more prevalent in the municipal market than the corporate and government bond markets. The average price of newly issued municipal bonds is $115 - $116 whereas corporate and government bonds are typically issued at $100 - $101.

As the holiday season gets nearer, it's prudent to seek discounts when shopping for gifts. But if you're shopping for municipal bonds, look for premiums instead.

For more information, please contact your Key Private Bank Advisor.

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