MSRB

# About Premium Municipal Bonds

A premium municipal bond is a security purchased at a price in excess of its par value and with a coupon rate that is higher than the prevailing market interest rate. This means that a premium municipal bond will sell for more than 100 percent of its par value. The illustration below provides a hypothetical example comparing two $1,000 par value municipal bonds maturing in 10 years and not subject to prior redemption.[1] In general, premium bonds are less volatile during periods of rising interest rates.

| FEATURES | PREMIUM MUNICIPAL BOND | PAR MUNICIPAL BOND |
|---|---|---|
| Annual Coupon | 5.50% | 4.00% |
| Yield to Maturity | 4.00% | 4.00% |
| Price | 112.264/ $1,122.64 | 100/ $1,000 |
| Principal at Maturity | $1,000 | $1,000 |
| Coupon Payment (annual amount based on 10 bonds) | $550 | $400 |
| Premium Paid | 122.64 | 0 |
| Net Cash Flow[2] | $427.36 | $400 |

In the example above, which assumes that the municipal bond was held to maturity, the higher coupon of the premium municipal bond resulted in an additional net cash flow of $27.36 over the life of the bond despite the initial cost being $122.64 above par value. Note that over the life of the bonds the premium must be amortized.

When investing in premium municipal bonds, investors should consider the potential benefits and the potential risks associated with these investments.[3] There may be tax implications associated with premium municipal bonds that should be considered when deciding on the most appropriate investment option. Consult your investment adviser and/or tax advisor for additional information.

## Potential Benefits

Among the potential benefits associated with a premium municipal bond are:

- **Increased Cash Flow** — Premium municipal bonds have higher coupon rates than comparable securities selling at par or at a discount.[4] While premium municipal bonds are priced above par, the additional cash inflow received from the higher coupon may offset the initial higher cost.

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[1] All values used are for illustration purpose only.

[2] The net cash flow is the total coupon payment of $550 less the additional premium of $122.64 paid at the time of purchase.

[3] The MSRB is providing this material for educational purposes only. This information is neither a legal interpretation nor a statement of MSRB policy nor an investment recommendation. If you have questions about premium municipal bonds, please consult your investment adviser and/or tax advisor.

[4] Discount is the difference between the price paid for a bond and its par value or compound accreted value.

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- **Reduced Volatility** — Since premium municipal bonds have higher coupon rates and larger cash flows, the price sensitivity to movements in interest rates is lower. Consequently, their prices tend to increase or decrease less rapidly than comparable securities sold at par or at a discount.
- **Tax Protection** — In certain circumstances, the discount associated with purchasing discount municipal bonds may be subject to either capital gains tax or be taxed as ordinary income and as a result the market value of these bonds will be reduced. Premium bonds may provide investors with protection from any associated market discount costs.

## Potential Risks

Among the potential risks associated with a premium municipal bond are the following:

- **Interest Rate Risk** — As with all fixed income securities, the value of a bond will change due to a change in the overall market interest rate. Although premium municipal bonds have less price sensitivity to a change in interest rates than par bonds, overall interest rate risk should be considered when investing in any type of fixed income instrument.
- **Secondary Market Risk** — The risk that an investor will not be able to trade a bond in the secondary market. While such risks exist for any type of fixed income security, premium municipal bonds may be harder to trade depending on the interest rate environment at the time of sale.
- **Reinvestment Risk** — The risk that interest rates may be lower than the yield on a fixed income security when the owner seeks to reinvest interest income received from the security. The term also sometimes refers to the risk that principal repayments on such a security may be paid prior to maturity (*e.g.*, at call date), thereby forcing the owner to seek reinvestment of principal at a time when interest rates may be lower than the rate that was payable on the security. During a period of falling interest rates, the income stream of a premium municipal bond may have to be reinvested at a lower interest rate. This risk effects all coupon bearing fixed income securities, but is greater for premium bonds relative to par or discount bonds.
- **Call Risk** — To the extent that the premium bond is subject to redemption prior to the stated maturity date, the risk that the issuer will use a redemption feature to redeem the bond prior to its final maturity. If a premium municipal bond is called, the proceeds may have to be reinvested at lower interest rates. Investors should consult with their investment advisers to better understand the relationship between call dates, yield-to-call, yield-to-maturity and premium municipal bonds.

## Reported Yield on Statements

Premium bonds have higher coupon payments and as a result can generate greater cash flow. However, investors should remember that part of the coupon payment on a premium bond is actually the return of principal. There are tax implications that should be considered and discussed with your tax advisor and/or investment adviser.

Here's an example:

An investor has two options in the market when buying $10,000 par amount of bonds. Both are ten-year bonds that are not subject to prior redemption: one is priced at par and one is priced at a premium.

| BOND | COUPON | YIELD TO MATURITY | INITIAL BOND PRICE | TOTAL COUPON PAYMENT | INITIAL CASH FLOW | VALUE AT MATURITY |
|---|---|---|---|---|---|---|
| ABC | 3.00% | 3.00% | $100.00 | $3,000 | -$10,000 | $10,000 |
| DEF | 5.00% | 3.00% | $117.13 | $5,000 | -$11,713 | $10,000 |

In the example above, although the coupon payments on premium bond DEF are $200 more per year than par bond ABC, some of that is attributable to the premium paid upfront to purchase the bond with the higher coupon. Remember, both bonds pay back the same principal amount of $10,000. It is important to note that although bond DEF's coupon payments over the life of the bond are $2,000 more than bond ABC ($5,000 – $3,000), this is partially offset by the $1,713 premium paid at the time of purchase.[5]

The annual income estimated on an account statement is provided on a pre-tax basis, and the Internal Revenue Service requires amortization of the municipal bond premium although the municipal bond's interest is not federally taxable. Although the municipal bond's interest is not federally taxed, the interest and annual amortized amount of the premium bond is required when filing tax returns. Your investment adviser or broker can provide the annual amortized amounts.

**Consult your investment adviser and/or tax advisor to discuss the potential tax implications associated with premium municipal bonds.**

[5] Note calculations assume that all principal and coupon payments are made in full and as scheduled.

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