Paying a Premium

Bond investors are like outlet mall shoppers. Everyone is looking for a big discount, the mall is super crowded, and the real bargains are elusive. In fact, a dirty little secret of the outlet mall business is that the discounted goods are often discounted quality too. You get what you pay for and discount prices are not all that they are cracked up to be.

We often have clients that wonder why we are willing to pay a premium price (say $130.00) for a security that on maturity date will be worth Par ($100.00). Bond investors, like the outlet shoppers, would prefer to see discount purchase prices (say $95.00) on their client statements. The first and most obvious answer to the premium question is that because of a decade of falling interest rates, the investable inventory of bonds in the marketplace is almost entirely premium bonds. (Recall that when a bond is issued and the prevailing rate of interest subsequently falls, that previously outstanding bond now trades at a premium price.) The second important part of the answer is that price return is only one component of total return – the other being coupon return. In many cases, we are willing to forgo price return (even accept a negative price return) if the coupon return is so attractive that the resulting TOTAL return benefits our client portfolios.

Beyond the mechanics of total return and the "premium bond" universe in which we operate today, there are reasons to actually PREFER premium bonds. Here are three of those reasons:

1. Premium bonds by definition have higher coupons than discount bonds. Higher coupons mean relatively higher cash flows over the life of the investment. If your expectation is that rates will rise from the historic low levels that currently prevail, the premium bond offers more reinvestment opportunity at the higher rates as the higher coupon streams get paid out.

2. Premium bonds are potentially less price sensitive to interest rate movements. Because of the relatively higher cash flow stream (more money up front), the premium bond usually has a shorter duration (interest rate sensitivity).

3. Lastly, the marketplace for discount bonds is often like the crowded outlet mall. Buyers love discounts and so the pricing of discount bonds can get inflated relative to that of premium bonds. More often than not, we find tremendous relative value in premium bonds. Premiums are usually older issues that can get left behind by investors focused on "on the run" (Par priced) securities or that might be constrained by investment policy to buy only lower priced securities. As a result, premium bonds can offer extra yield.

An important risk that premium bonds bear is greater loss in a default scenario. Obviously, the higher the purchase price, the higher the loss if the bond issuer cannot pay. To some extent, this risk is a contributor to the aforementioned extra yield reward. However, the likelihood of default in investment grade bonds is remote. In our judgment, the extra yield far outweighs the risk. In fact, some of the highest coupon bonds in our universe are among our favorites to hold in our client portfolios. Here is a good example of a favorite, the United Technologies Corp. 8.875% bond, compared to a lower coupon bond of the same issuer:

Bond	UTX 8.875% 11/2019	UTX 4.50% 4/2020
Maturity	6 years, 10 months	7 years, 3 months
Coupon	8.875%	4.50%
Price (12/31/12)	$135.70	$116.58
Yield to Maturity	3.05%	2.03%
Duration	5.40 years	6.25 years
Deal Size	$235MM	$1,250MM
Rating	A2/A/A	A2/A/A

Both bonds in this example are premium bonds; however, the 8.875% bond is obviously carrying a coupon far above the prevailing rates of interest for 7-year corporate bonds. Additionally, the 8.875% bond issue happens to be a small issue size amongst the various United Technology debt issues. Because of the illiquidity associated with small deals and because of the large premium dollar price for this issue, the bond investor is rewarded with an extra 100 basis points of yield. That reward strikes us as good value. While discount shoppers are looking for bargains at the crowded outlet mall, we think it makes sense to rummage around in the "premium bin."

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	0.22%	4.22%	6.19%
Barclays Int. Aggregate	0.18%	3.56%	5.22%
Barclays Govt/Credit	0.38%	4.82%	6.71%
Barclays Int. Govt/Credit	0.35%	3.89%	5.19%
Barclays 1-3 Year G/C	0.15%	1.26%	1.88%
Barclays 1-10 Year TIPS	0.46%	5.04%	6.38%

Source: Barclays Capital *As of December 31, 2012*

Treasury Market Yields

	12/31/12	9/30/12
3 Month	0.04%	0.09%
2 Year	0.25%	0.23%
5 Year	0.72%	0.63%
10 Year	1.76%	1.63%
30 Year	2.95%	2.82%

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