BUYING MUNICIPAL BONDS AT A PREMIUM

Does it make sense for investors to purchase bonds above par value?

- Buying "premium" bonds is a defensive fixed income approach as interest rates remain near historic lows.
- Economists have suggested the Federal Open Market Committee will initiate rate hikes only after the inflation rate exceeds the current inflation target.
- Considering that rates are still extremely low, we believe there is a near-term opportunity to include premium municipal bonds in fixed income portfolios.

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Where Investments and Values Intersect

Executive Summary

With interest rates still near generational lows, the Federal Open Market Committee (FOMC) may be inclined (or forced) to raise short-term interest rates should inflation exceed its inflation target. One tax-friendly, fixed income investment approach in a low-interest-rate environment includes premium municipal bonds in the building of portfolios. Premium bonds (bonds sold at a premium or above par) are a defensive play when interest rates are low and likely to increase. When purchasing bonds at a premium, the investor pays a higher initial cost in anticipation of the increased cash flow from larger interest payments later.

Future FOMC Actions

Although the rise/decline of the Federal Funds Rate is never subject to precise calculations, the FOMC will alter this rate to adjust for economic pressure. The FOMC guidance of allowing inflation to exceed its target rate has led to speculation and debate about the speed and size of future rate changes. How much or how quickly rates adjust following the initial action is anyone's guess. The consensus among economists suggests limited but gradual rate changes will occur until the Federal Funds Rate approaches or exceeds the inflation rate. While nothing is ever certain, the FOMC always has the latitude to alter short-term Federal Funds Rates to meet its dual mandate.

Premium Municipal Bonds in a Rising Rate Economy

Typically, bond values fall when interest rates rise and increase in value when interest rates fall. Discount bonds (those selling below par value), par bonds (at par value), and premium bonds (above par value) are all susceptible to falling prices that often result from rising rates. With this in mind, why would an investor want to buy a municipal bond – let alone any bond *above* face value – when rates could rise in the future? Premium bonds might offer a helpful answer.

Although premium bonds do not provide immunity to rising rates, there are benefits that might settle unease among investors worried about the value of their fixed income portfolios in a rising rate economy.

Advantages of Buying Premium

Higher coupon: While premium bonds are more expensive, they also come with higher coupon rates. As such, the larger initial investment brings a higher coupon rate. Therefore, the higher initial cost of purchasing premium municipal bonds is offset by increased cash flow throughout the life of the bond. The higher cash flows result in the benefit of a shortened duration and the opportunity to reinvest interest and principal at higher rates.

Shorter duration: Purchasing premium bonds (rather than par or discount bonds) results in a shorter duration. This concept is crucial for bond investors to understand. The longer the duration, the longer the time before an investor's principal (initial investment) is returned. Consequently, a shorter duration often means a quicker return of principal, which derives from a higher coupon issue's accelerated cash flows. Duration is also significant because it gives the investor an idea of how much a bond's price will fluctuate when interest rates change. Simply put, lower duration means lower sensitivity towards changing rates and higher stability and liquidity of the principal.

Reinvestment: The shorter duration and increased cash flow from the higher coupon premium bond allows the reinvesting of interest and principal at higher rates in the future. If interest rates continue to rise, premium bonds become more attractive for reinvestment. The higher interest rates go, the greater the advantage premium bonds have over par or discount bonds.

Risks of Buying Premium

Risks of bonds include, but are not limited to: changes in interest rates, liquidity, credit quality, volatility, and duration. One of the most significant risks when investing in any premium bond is the chance it could be called before maturity. In this scenario, the investor would not have sufficient time to earn a "profit," given the larger initial investment needed to purchase the bond at a premium. The investor would experience a net cash flow decline. However, bonds are typically called away when rates are decreasing, to be reinvested at a lower rate. Crossmark avoids purchasing bonds with a negative yield-to-worst case scenario. Considering that rates are still near generational lows, we believe there is a near-term opportunity to include premium municipal bonds in fixed income portfolios.

Conclusion

Crossmark Global Investments features an experienced team of fixed income specialists who understand the risks and opportunities involved in purchasing premium municipal bonds in a constantly changing marketplace. Through consistent portfolio analysis, Crossmark continues to seek the best value in tax-friendly, fixed income investments in the current rising rate economy. Crossmark is always mindful of liquidity, credit quality, volatility, duration, and the potential for future FOMC interest rate hikes. By using short-duration and premium callable bonds to strategically position portfolios, Crossmark is uniquely equipped to help investors meet their fixed income objectives – maximizing tax-free returns and minimizing risk.

Our Firm

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