CROSSMARK
GLOBAL INVESTMENTS ™

INVESTING IN PREMIUM BONDS

- Premium bonds, or "cushion bonds," are a defensive approach as interest rates are projected to rise.
- Economists have suggested limited but gradual rate changes will take place until the Federal Funds Rate approaches the inflation rate.
- Considering that rates have begun to rise for the first time since 2006, it appears there is "no time like the present" to include premium bonds in fixed income portfolios.

Executive Summary

With interest rates moving higher from generational lows, the Federal Open Market Committee (FOMC) may continue to be inclined, or forced to raise short-term interest rates. One fixed income investment approach in a rising interest rate environment is to include premium bonds in the portfolio construction. Premium bonds, or "cushion bonds," are a defensive play as interest rates rise. Buying premium bonds is essentially paying a larger initial cost, in anticipation for more cash flow from larger interest payments later.

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Rising Rates

Although the rise/decline of the Federal Funds Rate is never subject to precise calculations, The Federal Open Market Committee will alter short-term Federal Funds Rate to accommodate economic pressures. The initial rate hike since 2006 began in December 2015 which has led to speculation and debate as to the speed and size of future rate changes. How much or how quickly rates adjust following the initial adjustment is anyone's guess. Economists have suggested limited but gradual rate changes will take place until the Federal Funds Rate approaches the inflation rate. While nothing is ever certain, the Federal Open Market Committee has altered the short-term Federal Funds Rates.

Premium Bonds in a Rising Rates Economy

Typically, bond values fall when interest rates rise, and rise in value when interest rates fall. Discount bonds (below face value), par bonds (at face value), and premium bonds (above face value) are all susceptible to falling prices that often come with rising rates. With this in mind, why would an investor want to buy a bond – let alone a bond *above* face value – when rates are expected to rise? Premium bonds might offer a worthwhile answer.

Although the rise/decline of the Federal Funds Rate is never subject to precise calculations, the FOMC will alter short-term Fed Funds rates to accommodate economic pressures.

Although premium bonds do not provide immunity to rising rates, there are perks to buying premium bonds that might settle the uneasiness of investors finding themselves worried about purchasing bonds in a rising rates economy.

Advantages of Buying Premium

Higher coupon: Premium bonds are more expensive; however, they also come with a higher coupon rate. This means that while there is a larger initial investment, a higher coupon rate brings an accelerated cash flow. Therefore, the initial higher cost of purchasing premium bonds is offset by the increased cash flow throughout the life of the bond. With a higher cash flow come the benefits of the bond having a shorter duration, and the opportunity to reinvest at a higher rate in a rising rate period.

Shorter duration: Purchasing premium bonds over par bonds or discount bonds results in a shorter duration. Understanding duration is crucial when it comes to investing in bonds. 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 the accelerated cash flow of a higher coupon. Duration is also important because it gives the investor an idea of how much a bond's price will fluctuate when interest rates change. To put it simply, lower duration means lower sensitivity towards changing rates, as well as higher stability and liquidity of the principal.

Considering that rising rates are potentially on the horizon, it appears there is "no time like the present" to include premium bonds in fixed income portfolios.

Reinvesting: Aside from decreasing duration, or risk, the increased cash flow from the higher coupon leads to the option of reinvesting at higher rates in the future. If interest rates prevail to rise, premium bonds become more attractive for reinvestment. In fact, 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 greatest risks when investing in premium bonds is the chance that the bond could be called prior to maturity. Thus, rendering the investor with a larger initial investment spent without the bond having enough time to return a profit to the investor. In such a case, the investor would experience a net cash flow decline. However, bonds are typically called away in a time 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 rising rates are potentially on the horizon, it appears there is "no time like the present" to include premium bonds in fixed income portfolios.

Conclusion

Crossmark Global Investments' experienced team of fixed income specialists understands the risks and opportunities involved in purchasing premium bonds in a constantly changing marketplace. With consistent portfolio analysis, Crossmark seeks to capitalize on fixed income investments in an expected rising rate economy. Crossmark has intentionally made investments that are mindful of FOMC interest rate hikes. By using short duration and premium callable bonds to strategically position portfolios, Crossmark is equipped to uniquely place investments in order to seek a maximized return and minimized risk.

About Crossmark's 30 Year History

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