NORTHERN TRUST
ASSET MANAGEMENT

# PREMIUM BONDS: BE CAREFUL WHAT YOU SPEND

We recently shared a piece describing the risk management benefits of premium coupon bonds[1]. But that benefit may come with a warning: if you spend the entire premium bond coupon income, you may be spending some of your principal, disguised as coupon interest.

Accountants and tax authorities already take into account that these periodic coupon payments on premium bonds include both the market rate of interest and a portion of invested principal. They record it through amortization of the bond premium paid at purchase.

But in the real world of your spending and investing decisions, what **IS** the right balance of spending and reinvesting? Investors have more than an accounting view, and need practical advice and rules of thumb.

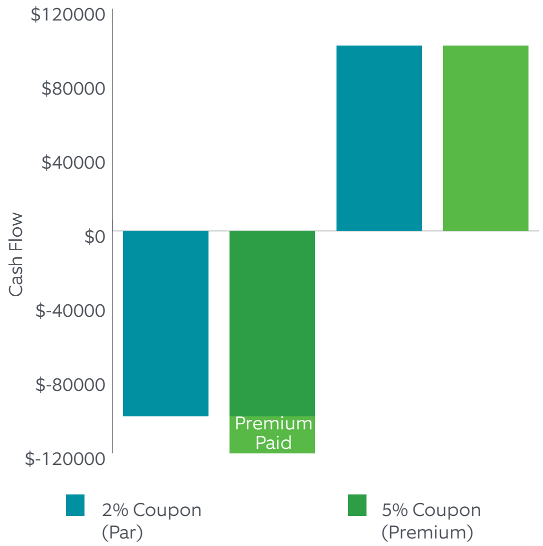
To set the 'correct' amount of the 'extra' income to spend, an investor should consider a number of factors, including:

- What are my lifestyle requirements?
- Do I care if I spend down some of the principal?
- How does this cash flow fit into my whole investment picture (considerations like inflation protection or taking additional risk to aim for capital appreciation)?

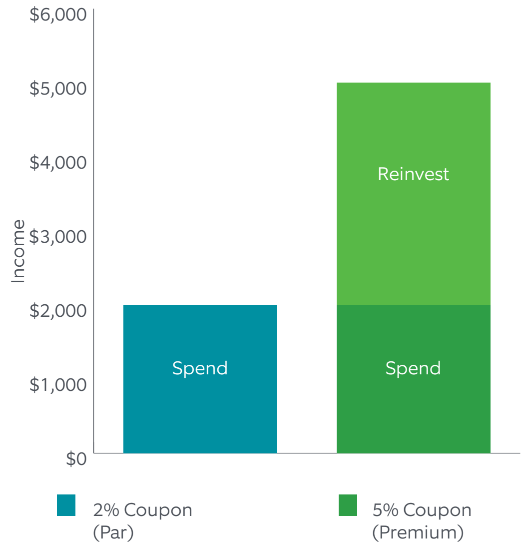
When a bond trades at a premium, the market price of the bond is higher than $100 because investors are being promised coupon payments that exceed current market interest rates.

1 Why Should I Pay a Premium…and Be Happy About It?

**BOND CASH FLOWS- BEGINNING AND ENDING (EXAMPLE)**




**ANNUAL COUPON - SPENDING POLICY PROPOSAL (EXAMPLE)**




Source: Northern Trust Asset Management – Fixed Income

The graphic shows the difference in the 'lump sum' cash flows on two bonds – a par purchase and a premium. At maturity, they both pay out the same par amount.

The initial costs are obviously different - and so are the periodic income payments. The par bond pays a coupon that matches the current rate (at purchase date) for that type of maturity and credit risk. The premium bond pays a *higher-than-market rate* for that same maturity and credit profile. **The higher coupon income is what justifies the higher-than-par purchase price.**

To focus exclusively on the 'spend now vs preserve principal' question, **we suggest using the level of market- rate-at-purchase as a starting point for sustainable spending rate**. In the example above, 2% of the coupon income would be spent and 3% would be set aside for reinvestment.

**Things Change – Your Coupon Spending Plan Can Adjust**

One advantage of this proposed approach is that it can adjust to new market realities.

For example, if interest rates were to rise (usually from new expectations of higher economic growth and/ or inflation), then reinvesting income and any new investments will be made at the then-higher rates.

Using our proposed guideline, the portion of that new investment's premium coupon income that could be spent would also be *higher* than the 2% level noted in our graphic. It would be the new, higher market rate at the time of the new purchase.

### CONCLUSION

Successful Fixed income investing can be confusing. But the asset class also has some useful features that can deliver valuable and effective benefits as part of meeting an investor's overall goals.

Investors often have various objectives for their bonds:

- Risk control (expected lower market value volatility than riskier assets),
- Predictability of cash flows, and
- Income.

The specific mix of those needs will vary by investor and often change over time. The right answer – at a point in time and over time – may be best considered with the assistance of an investment professional or advisor.

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**northerntrust.com** Q62744 (7/19)