Premium Bonds: What Makes Them So Valuable?

A premium bond is one that you buy on the secondary market for more than par value ($1,000). For example, if you purchase a bond with a 9% coupon (when other newly issued bonds are only paying 7%), you might pay $1,150 for it. You willingly pay more than $1,000 for the bond because it generates more income every year ($90/year) than 7% offerings ($70/year) produce. When it matures, you will receive $1,000, which is less than what you originally paid. The difference, $1,150 - $1,000 = $150, is called the "premium." You accept that $150 loss because, when you first bought the bond, you knew that you would more than make up the loss of premium by getting higher coupon payments every year. Had you bought a bond at par, you would have gotten lower annual payments and not lost the premium. In general, you will end up with a fairly similar yield to maturity regardless of whether you buy the premium bond or the bond trading at par.

As an investor looking forward to receiving a predictable cash flow, consider the advantages of buying premium bonds:

- Because many price-conscious people never like to pay more for a product than the listed value, premium bonds will sometimes trade at a slightly lower price than you might expect (based on your calculations of returns), and their yield to maturity would be a bit higher than low-coupon bonds selling at a discount or new bonds selling at par.
- Premium bonds pay a higher coupon rate than discount or par bonds. Thus, each year you will receive more cash in your hand. With this extra money you can go shopping, pay your bills, or reinvest and earn interest on your earnings.
- During a period of increasing interest rates, premium bonds can make sense. For example, if you hold a bond with a 7% coupon while your neighbor keeps his 4% issue, as rates move up to 7% and beyond, your coupon will seem more in line with general expectations compared with his lower coupon of 4%. That higher coupon may cushion your bond, helping it retain more of its value than its lower coupon counterpart. The prices of bonds move inversely to interest rates. As such, if you want bonds that retain value in a rising interest environment, consider choosing premium bonds.