Tapping Into Maple

Bond Basics—Understanding Premium and Discount Bonds

When investors purchase bonds they encounter terminology like premium, discount or par. Knowing what these words mean can help investors make better decisions about which bonds to purchase and understand how the bonds should behave after they have been added to their portfolio.

Generally in life the term discount signifies a good value. If you go to a car dealership and get a discount that's a good thing. When buying a bond, discount generally does not signify a better value, but rather a different cash flow stream compared to a par bond. The same applies to a premium bond. In both cases the coupon rate received while owning the bond differ from the prevailing market rates at that point in time. Therefore the price must adjust to make the two rates close to equal.

- A Discount bond has a coupon that is **below** current market yields for a similar rated issue.
- A Premium bond has a coupon that is **above** current market yields for a similar rated issue.
- Since the coupon is different than the prevailing market yields for a similar rated issue, the price is simply adjusted to equate the yield on the bond to the prevailing yields.

Bond Prices Reflect Different Coupons

Market Interest Rate (Yields)	3%	3%	3%
Coupon Rate	2% (Discount)	3% (Par)	4% (Premium)
Face Value	$1,000	$1,000	$1,000
Yield to Maturity	10 Years	10 Years	10 Years
Price	$918.24	$1,000	$1,090.23

The premium or discount, together with the coupon rate, is used to determine the yield to maturity (YTM), also called the yield to worst (YTW) if there are embedded calls, which represents the investor's expected yield on the investment.

Important terminology to note:

- Coupon Rate: The rate of interest paid by the bond issuer on the bond's face value.
- Face Value/Par Value: The amount paid to the bondholder at the maturity date.
- YTM/YTW: Yield to maturity or yield to worst is the potential yield the buyer can receive from a bond. Note that this is not the same as the coupon rate.

Here at Maple Capital, we take all of this into consideration when evaluating bonds. In addition we assess other important details like the tax status of the account purchasing the bond, the other bonds already held in the account and their sensitivities to interest rates, the cash flow needs of the account, issuer rating and stability, and the liquidity of the bond. We hope this short explanation helps to make some sense of some bond market terminology if you are looking to do some fixed income investing after Thanksgiving!

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