The case for premium bonds



Key takeaways

- Bonds trading above par are common across bond markets, especially municipals.
- Bonds often trade at a premium when its coupon rate is higher than current market yields.
- Most municipal bonds are issued at a premium and often continue to trade that way due to their tax advantages and higher coupons.

What is a premium bond?

A premium bond is a bond that trades above its face (par) value, typically because it offers a higher coupon than newly issued bonds of similar maturity and credit quality.

Why investors consider premium bonds

Higher Income:

Premium bonds typically offer higher coupon payments, which may provide greater cash flow as compared to non-premium bonds.

Interest Rate Sensitivity:

As a result of the higher coupon, premium bonds are generally less sensitive to changes in interest rates and therefore have a lower duration[1] as compared to non-premium bonds, all else being equal.

Comparable Yields:

Yields can be similar to other bonds with comparable credit quality and maturity when held to maturity.

Liquidity:

Premium bonds do not inherently offer greater liquidity. However, they may attract stronger demand—particularly in the municipal bond market—due to higher income levels. Liquidity varies by bond and market conditions and is not guaranteed.

Tax Treatment:

Purchasing bonds at a premium may help limit exposure to the market discount rule. For discount bonds, the difference between purchase price and par value may be taxed as ordinary income upon sale or redemption. Tax treatment varies; investors should consult a qualified tax professional.

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Why bonds trade at a premium

Bonds—whether U.S. Treasuries, corporate bonds, or municipal bonds—can be issued or traded at a premium. This typically occurs when a bond's coupon exceeds prevailing market interest rates. While this dynamic applies across all sectors, premium pricing is most common in municipal bonds, often driven by tax-related investor preferences.

1. Interest Rates

When market interest rates decline after issuance, bonds with higher coupons become more valuable: For example, a bond paying a 5% coupon in a 3% market offers relatively higher income, which may lead investors to pay above par for that income stream. As a result, the bond trades at a premium. This dynamic applies to Treasuries, corporate bonds, and municipal bonds in both primary and secondary markets.

2. Tax Considerations (Most Relevant for Municipal Bonds)

Interest income from Municipal bonds are often exempt from federal—and sometimes state and local—income taxes. This tax advantage can make their after-tax yield more attractive than similarly rated taxable bonds. As a result, investors—particularly those in higher tax brackets—may be willing to pay a premium. This is a key reason why premium pricing is especially common in the municipal market.

3. Supply and Demand Dynamics

Prices across all bond sectors are influenced by market demand: Strong demand for bonds with desirable characteristics—such as high credit quality or limited issuance can push prices above par. This occurs in Treasuries (flight to quality), corporates (credit and yield demand), and municipals (state-specific or tax-driven demand). In municipals, limited supply combined with strong demand for tax-advantaged income can further support premium pricing.

4. Bond Structure and Features

Certain bond features can increase a bond's value and support premium pricing:

- Higher coupon structures
- Longer call protection or non-callable features
- Strong credit quality

These features can apply across all bond sectors. However, municipal bonds are often structured with higher coupons, which increases the likelihood they will trade at a premium.

Premium bonds and interest rates

The illustration compares three municipal bonds with the same maturity and credit quality—priced at a discount, at par, and at a premium—to show how return is distributed.

How a premium bond compares to other bonds with the same face value[1]

	Discount bond	Par value bond	Premium bond
Price	$9,432	$10,000	$12,053
Coupon (%)	2.00%	2.65%	5.00%
Annual interest paid	$200	$265	$500
Effective duration[2]	9.08	8.85	8.20
Tax-equivalent yield (%)[3]	4.21%	4.21%	4.21%

1. Illustrative calculation. The above assumes newly purchased bond having a maturity date in 10 years.

2. Effective duration estimates the approximate change in price for a bond if interest rates change 100 basis points.

3. Tax-adjusted equivalent calculation uses a generic tax rate of 37% and provides a comparison of yield to taxable securities.

Discount is a bond traded for less than face value, par is a bond that trades at face value, and premium is a bond that trades at a price higher than face value.

What the illustration shows:

- All three bonds have the same value at maturity and deliver a similar overall tax-equivalent yield.
- The key difference is how returns are delivered:
    - Premium bond: higher price, higher income, lower duration
    - Par value bond: Balanced price and income
    - Discount bond: Lower price, lower income, higher duration

Bottom Line: Premium bonds generally return more cash up front, while discount bonds usually rely more on price appreciation.

Premium bonds cost more than par but typically pay higher interest, compared to non premium bonds. This higher income can help reduce sensitivity to rising interest rates (lower duration). As a result, premium bonds have historically held up better when rates rise but may lag when rates fall. Premium bonds shift return toward income and away from price movement, which can help manage interest rate risk.

Important fixed income risks to consider

Call Risk

Callable bonds may be redeemed early by the issuer, particularly when the bond's interest rate is higher than current market rates. As a result, investors should pay close attention to the earliest call date and the bond's yield to worst.

Credit risk

Bond values reflect the issuer's financial health. For example, while investment-grade[2] municipal bonds have historically low default rates†, weaker economic conditions can raise credit risk and pressure prices.

†Source: Moody's Investor Service "US Municipal Bond Defaults and Recoveries, 1970-2023, October 24,2024

Taxes

Tax treatment can vary, so it's important to understand the potential impact. Consider consulting a tax professional.

Diversification

It's important to maintain a diverse mix of investments in any fixed income portfolio. A properly diversified portfolio includes securities from a variety of sectors, with different credit ratings and maturities, to help manage both credit risk and interest rate risk.

Bringing it all together

Premium bonds can offer attractive cash flow and potential risk-management benefits—but evaluating trade-offs like price, yield, tax impact, and interest rate sensitivity can be complex.

That's where professional management can add value. Experienced fixed income managers actively evaluate these factors, helping ensure that each bond fits within a broader portfolio strategy aligned with your income needs and long-term goals.

For investors seeking a more tailored approach, a Fixed Income Separately Managed Account (SMA) provides direct bond ownership with ongoing oversight, allowing portfolios to be customized and adjusted as market conditions evolve.

Connect with a Fidelity professional to discuss how premium bonds and a tailored fixed income strategy may fit into your overall portfolio.

1. Duration is a measure of a security's price sensitivity to changes in interest rates. Duration differs from maturity in that it considers a security's interest payments in addition to the amount of time until the security reaches maturity and also takes into account certain maturity shortening features (e.g., demand features, interest rate resets, and call options) when applicable. Securities with longer durations generally tend to be more sensitive to interest rate changes than securities with shorter durations. A portfolio with a longer average duration generally can be expected to be more sensitive to interest rate changes than a portfolio with a shorter average duration.

2. Investment-grade bonds are bonds rated BBB– /Baa3 or higher by S&P and/or Moody's, respectively. Such ratings indicate that a municipal or corporate bond has a relatively low risk of default.

This information is intended to be educational and is not tailored to the investment needs of any specific investor. Investment decisions should be based on an individual's own goals, time horizon, and tolerance for risk.

Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to loss.

The municipal market can be affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Such changes can affect the tax treatment of municipal bonds. Interest income generated by municipal bonds is generally expected to be exempt from federal income taxes and, if the bonds are held by an investor resident in the state of issuance, state and local income taxes. Such interest income may be subject to federal and/or state alternative minimum taxes. Investing in municipal bonds for the purpose of generating tax-exempt income may not be appropriate for investors in all tax brackets or account types. Tax laws are subject to change and the preferential tax treatment of municipal bond interest income may be removed or phased out for investors at certain income levels. You should consult your tax adviser for questions pertaining to your specific situation.

Diversification and asset allocation do not ensure a profit or guarantee against loss.

Past performance is no guarantee of future results.

Interest rate risk - Like all fixed income securities, the market prices of municipal bonds are susceptible to fluctuations in interest rates. If interest rates rise, market prices of existing bonds will decline, despite the lack of change in both the coupon rate and maturity. Bonds with longer maturities are generally more susceptible to changes in interest rates than bonds with shorter maturities.

Call risk - Many municipal bonds carry provisions that allow the issuer to call or redeem the bond prior to the actual maturity date. An issuer will typically call bonds when prevailing interest rates drop, making reinvestment less desirable for the holder. Some municipal bonds, including housing bonds and certificates of participation (COPs), may be callable at any time regardless of the stated call features. In some cases, bond issuers will call bonds to modify an indenture through a new offering. Investors should also be aware of special or extraordinary redemption provisions. These are provisions that give a bond issuer the right to call the bonds due to a one-time occurrence, such as a natural disaster, interruption to a revenue source, unexpended bond proceed, or cancelled projects.

Credit and default risk - Credit risk is the risk that the issuer will default or be unable to make required principal or interest payments. Despite the fact that many municipal bonds have high credit ratings, there is a risk of default in any bond investment.

Tax risks - Because tax-exempt interest generated by municipal bonds is usually more beneficial for investors in higher tax brackets, municipal bonds may not be appropriate for all investors, particularly those in lower tax brackets. In addition, if you are subject to the federal alternative minimum tax (AMT), the interest income generated by certain municipal bonds (mainly private activity bonds) may be taxable.

Fidelity does not provide legal or tax advice. The information herein is general in nature and should not be considered legal or tax advice. Consult an attorney or tax professional regarding your specific situation.

Tax-advantaged accounts such as IRAs and 401(k)s are generally not appropriate for holding tax-exempt municipal securities.

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