Bond Case Briefs

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Don't Be Afraid Of Buying Premium Bonds.

Mathematics can be challenging and complicated. Many people have an aversion to math. If you are a full-fledged do-it-yourself bond investor it's imperative you understand bond math and the IRS rules surrounding bond premiums. Finally, the brokerage firms have grasped the importance of bond math and have made it much easier for investors.

Many investors don't like paying over par for municipal or corporate bonds. The reason, as I see it, is because they don't understand the bond math. Why buy something at 115 ($1,150 per face value) only to receive 100 ($1,000 per face value) back?

First of all, the premiums paid on either a municipal or corporate bond do not just vaporize. Your brokerage firm amortizes the premium for you; that means it displays your adjusted cost.

In many Forbes columns I have encouraged investors who own taxable premium corporate bonds to deduct their corporate bond premiums against their income annually. You will find that amount on your year-end Form 1099. Those who don't take the annual deduction against the income must take a capital loss at maturity.

The rules are different, much different, for municipals. Premiums are not a deduction. But premium municipal bonds sold before maturity will generate a gain or a loss.

Here's an actual example:

A block of 550 Connecticut General Obligation bonds was purchased August 30, 2013 at 117.08 ($1,170.80 per bond). June 14, 2017 bonds were sold at 107.338 ($1,073.38 per bond). Most people would think this transaction generated a capital loss—not so. By June 14, 2017 the bond had been amortized (according to IRS rules) down to 106 and change, thereby generating a $5,055.94 capital gain.

It's important you check your online or monthly brokerage statements to get a bead on the adjustments to your bond prices over time. That adjusted cost is a moving number. It is the adjusted cost on your 1099 that is reported to the IRS.

We have seen premium bonds rally to greater premium prices and premium bonds sink into distressed discounts. The key lesson here is that for shorter bonds those premiums eventually dissipate the closer it gets to maturity.

Think about it as a magnet: the maturity date magnet pulls the bond premium closer and closer to par every year. We say in bond-speak, it is rolling down the yield curve.

These bond technicalities matter the most if such positions are held in taxable accounts like your family trust or in a joint tenants account. The important minutia is that if you decide to sell, your original cost basis isn't what is used. Instead, it is the adjusted cost.

That said, take a look at another example: If you purchased, as I did, 25 Advanced Auto Parts bonds at 112.06 in December 2014 the 5.75% due May 1, 2020; today they are priced roughly at 108.442. At first blush it looks like a loss if you sell. But it's not. Bonds have been amortized down to an adjusted cost of 106.34 for a $526 capital gain if sold at 108.442.

Rates inched up, rates inched down since 2014. Over the next three years the adjusted cost on these Advanced Auto bonds will roll down to par very quickly.

The moral of this column is: Harvest your gains and losses starting now. Don't wait until December when everyone else is. And equally important, don't be afraid of buying premium bonds.

Forbes

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Aug 24, 2017

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