

Municipal Yield Considerations and Principal Preservation

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IN TAX-EXEMPT MUNICIPAL SECURITIES

Premium Bond Impact on Municipal Yields

We often receive questions regarding the difference between a portfolio's current yield and its yield to maturity. In the current low nominal rate environment, the difference between these yields is significant and it is important for clients to understand how each yield is calculated and its impact on a portfolio.

To illustrate the difference, assume that a highly rated 3.00% five year non-callable bond is purchased at a 1.00% yield to maturity. The dollar price of this security would be approximately \$109.730. The current yield of this bond is 2.73% ($3 / 109.730 \times 100$).

Because municipal securities mature at par (\$100), the dollar price of this security will amortize as the maturity shortens. Assuming yield levels along the yield curve are unchanged, the bond's price will decline to \$107.822 (a 1.73% decline) as the bond's maturity declines to four years. Therefore, the bond's total return for the first year holding period is 1.00% (the current return of 2.73% minus the percent decline in price due to the amortization of the premium).

The total return of a premium bond consists of both the current return and the price change due to amortization. Current yield represents only what the bond is paying – yield to maturity represents what the investor is actually earning.

Portfolio Distributions and Principal Preservation

It is imperative that investors understand the yield associated with their portfolios as related to coupon payments, income distributions and principal adjustments.

The following table illustrates income flows and price changes associated with the security discussed above.

	<u>Price</u>	<u>Price Change</u>	<u>(A) % Price Change</u>	<u>Coupon</u>	<u>(B) % Current Return</u>	<u>(A+B) Total Return</u>
Initial	109.730					
1st Year	107.822	-1.908	-1.73	3.00%	2.73	1.00%
2nd year	105.896	-1.926	-1.78	3.00	2.78	1.00
3rd Year	103.950	-1.946	-1.83	3.00	2.83	1.00
4th year	101.985	-1.965	-1.89	3.00	2.89	1.00
5th Year	100.000	-1.985	-1.94	3.00	2.94	1.00

Assume that a \$1 million portfolio is constructed that has the characteristics of the bond mentioned above. That \$1 million could purchase securities with an approximate par value of \$911,327 (ignoring accrued interest). Over five years the portfolio will generate income of \$136,699 ($911,327 \times 3.00\% \times 5$ years). If all of this income is distributed, the principal value of the portfolio will erode to \$911,327 after the five year period. However, if income distribution is limited to approximately 1.00%, this bond's yield to maturity, there will be no principal erosion and the portfolio value of \$1 million will be maintained at the end of five years. It is important for investors to focus on what their portfolios are "earning" and make appropriate withdrawals if principal erosion is to be avoided.

*The security discussed above was utilized for illustrative purposes only. As a defensively styled manager, C.W. Henderson typically utilizes higher coupon, callable premium bonds in portfolio constructions. These types of securities are characteristically more defensive in nature than lower coupon, non-callable bonds. They limit portfolio volatility and provide protection against the risks of negative convexity (larger price declines in rising rate environments than price increases when rates fall by an equal amount) and de minimis (tax impact related to purchasing municipals at prices below par). However; higher coupon, callable securities can complicate the yield discussion.