March 24, 2011 - As an investor, you want your money to grow so that you can achieve your important goals, such as a comfortable retirement or college for your children. But you may also invest to increase your cash flow. In fact, without a strong cash flow, you may be forced to dip into your growth-oriented investments to pay for short-term needs -- and if you do this repeatedly, you could damage your prospects for attaining your long-term goals. That's why you'll want to look at different ways of boosting your cash flow -- one of which may be premium bonds.

To understand the nature of premium bonds, you'll first want to be familiar with the relationship between a bond's price and its interest rate. When a bond is issued, it sells for face ("par") value, which is the amount returned to the bondholder when the bond matures. This bond also comes with a "coupon" rate -- the interest rate that the bond will pay throughout its lifetime. So, for example, if you paid $10,000 for a 10-year bond with a coupon rate of five percent, you would earn $500 per year, every year. If you held the bond until it matured, you'd also get your $10,000 back, provided the issuer doesn't default. But if market interest rates move up to six percent, and you wanted to sell your five-percent bond before it matures, you'd have to offer it at a discount from the $10,000face value. Conversely, if market rates were to fall to four percent, you may be able to sell your $10,000 bond for more than its face value, because investors will be willing to pay a premium to earn the higher interest rate.

Now, let's flip the equation, so that instead of being a bond seller, you're a buyer. If you want to increase your investment income, you might be interested in a premium bond. You pay a premium for the bond in return for higher interest payments for the life of the bond, and, if you hold it until maturity, you'll still get the face value back (again barring a default).

Furthermore, because premium bonds pay higher interest, they also pay a greater proportion of their cash flow before they mature, in comparison to discounted or "par" bonds. This helps provide for greater price stability, so if interest rates rise or fall, premium bond prices typically will not decrease or increase as much as those of discount or par bonds.

Keep in mind that while premium bonds are attractive to you because of their higher interest rate, they are unattractive to bond issuers for the same reason. In fact, when market interest rates fall, some issuers may try to redeem ("call") these bonds so that they can issue new ones at the lower rates. Obviously, if your premium bond were to be called, your cash flow might take a hit. That's why, when investing in premium bonds, you might want to look for those that have at least limited call protection -- in other words, they can't be redeemed for a certain number of years.

Your portfolio should comprise a number of different investments designed to work together to meet your long-term financial goals. So give premium bonds some consideration as part of a well-diversified portfolio.

Before investing in bonds you should understand the risks involved, including interest rate risk,credit risk and market risk.

This article was written by Edward Jones for use by your local Edward Jones Financial Advisor.