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December, 2014

Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Four Questions to Ask Before You Open Your Wallet

Even if you have the best of intentions, it's easy to overspend. According to a Gallup poll conducted June 9-15, 2014,* 58% of people who had shopped during the previous four weeks said they spent more at the store than they originally intended to. Even if you're generally comfortable with how much you spend, you may occasionally suffer from a case of buyer's remorse or have trouble postponing a purchase in favor of saving for a short- or long-term goal. Here are a few key questions to consider that might help you fine-tune your spending.

How will spending money now affect me later?

When you're deciding whether to buy something, you usually focus on the features and benefits of what you're getting, but do you think about what you're potentially forgoing? When you factor this into your decision, what you're weighing is known as the opportunity cost. For example, let's say you're trying to decide whether to buy a new car. If you buy the car, will you have to give up this year's family vacation to Disney World? Considering the opportunity cost may help you evaluate both the direct and indirect costs of a purchase.

Some other questions to ask:

- How will you feel about your purchase later? Tomorrow? Next month? Next year?
- Will this purchase cause stress or strife at home? Couples often fight about money because they have conflicting money values. Will your spouse or partner object to your purchasing decision?
- Are you setting a good financial example? Children learn from what they observe. What messages are you sending through your spending habits?

Why do I want it?

Maybe you've worked hard and think you deserve to buy something you've always wanted. But are you certain that you're not being unduly influenced by other factors such as stress or boredom?

Take a moment to think about what's important to you. Comfort? Security? Safety? Status? Quality? Thriftiness? Does your purchase align with your values, or are you unconsciously allowing other people (advertisers, friends, family, neighbors, for example) to influence your spending?

Do I really need it today?

Buying something can be instantly and tangibly gratifying. After all, which sounds more exciting: spending $1,500 on the ultra-light laptop you've had your eye on or putting that money into a retirement account? Consistently prioritizing an immediate reward over a longer-term goal is one of the biggest obstacles to saving and investing for the future. The smaller purchases you make today could be getting in the way of accumulating what you'll need 10, 20, or 30 years down the road.

Be especially wary if you're buying something now because "it's such a good deal." Take time to find out whether that's really true. Shop around to see that you're getting the best price, and weigh alternatives--you may discover a lower-cost product that will meet your needs just as well. If you think before you spend money, you may be less likely to make impulse purchases, and more certain that you're making appropriate financial choices.

Can I really afford it?

Whether you can afford something depends on both your income and your expenses. You should know how these two things measure up before making a purchase. Are you consistently charging purchases to your credit card and carrying that debt from month to month? If so, this may be a warning sign that you're overspending. Reexamining your budget and financial priorities may help you get your spending back on track.

**Source: American Consumers Careful With Spending in Summer 2014, www.gallup.com.*

Helping Your Parents Manage Their Finances

Postponing a discussion about helping a parent with his or her finances increases the odds that problems could arise before that discussion takes place.

As the U.S. population gets older, more people, particularly baby boomers, are confronting a dilemma. As parents age, their ability to manage their own finances may decline. That can make it more likely that they may neglect the life savings they've worked so hard to accumulate or make costly mistakes with them. Even worse, they're more likely to fall victim to one of the fraudulent schemes that frequently target seniors. "Financial Fraud and Fraud Susceptibility in the United States," a September 2013 report prepared for the FINRA Investor Education Foundation, found that seniors were 34% more likely to lose money to fraudsters than were those in their 40s.

And yet many seniors, especially those who have always been independent and/or money-savvy, may be reluctant to accept advice or help from their children, or even discuss living expenses, health care plans, investments, or general estate planning. Sadly, postponing that discussion can increase the difficulty of tackling whatever problems may eventually arise.

What's behind parental reluctance?

Suggesting that parents might benefit from assistance, either from their children or a professional, may remind them of their own mortality. People are living longer; if they're still active and involved, they may have difficulty accepting that their current good health and financial comfort may not always continue.

Also, some seniors may be reluctant to discuss finances because it can reinforce a sense of loss; this could be especially true if they can no longer drive or participate in activities they enjoy. Admitting that they need help with financial issues may make them feel as though one more area is no longer under their control. If this is the case, they might respond to the idea that addressing important issues now--planning for ill health or an incapacity--could give them greater decision-making power over their quality of life later.

Parents also may be uncomfortable discussing finances with only one child, preferring to involve all siblings. In this case, you may need to either try to reach a consensus about which child is best equipped to help, or divide responsibilities among siblings. For example, one child might assist with billpaying and day-to-day expenses while another reviews investments or handles health insurance, Medicare, and Social Security.

In some cases, parents may respond to the idea that taking action sooner rather than later can help prevent the loss of much of their hard-earned savings to taxes or scams. If they're uncomfortable discussing finances with you, you could suggest working with a third party who can review their situation and make recommendations that could then be discussed jointly.

When to offer help

Here are some signs that a parent might need some assistance: confusion about whether direct-mail offers are advertising or bills; failing to pay bills or file documents properly, especially if someone has always been highly organized; complaints about being unable to make ends meet; talking about the merits of certain investments, especially unfamiliar ones and especially if a parent hadn't previously exhibited much interest in investing; unusual behavior, such as making unexpected large purchases or spending a lot of time gambling.

Be sure to rule out other physical problems, such as an infection or difficulties with vision or hearing, before assuming that mental confusion is automatically a sign of dementia.

A start is better than nothing

If parents are reluctant to discuss specific figures, try to make sure that key information, including online account information and passwords, is on paper, and that someone else knows the location of those items and will be able to access them if necessary.

You might start providing assistance in stages. Offer to review checking account statements and/or credit card bills to ensure they're not paying for services they want to cancel or didn't request; this may give you insight into the overall state of their finances. Because seniors may be more willing to discuss issues such as health insurance and preferences regarding long-term care or end-of-life decisions before other topics, building trust in these areas could increase comfort levels on both sides with other matters.

If a trust has been set up, a trustee might be the logical person to handle finances, since he or she may eventually have to deal with trust-related issues anyway. The same is true for someone who has been granted a durable power of attorney, even if he or she doesn't yet have full responsibility for managing finances. And in a worst-case scenario, children can petition a probate court to name a conservator or guardian. Whatever approach you take, one of the key challenges of this process is to respect a parent's dignity while protecting his or her ongoing well-being.

[1] *This hypothetical example is not intended to reflect the actual performance of any specific investment, nor is it an estimate or guarantee of future value.*

[2] *If you wait until April 15, 2016, to actually withdraw funds from the Roth IRA to pay the conversion taxes, do you need to worry about paying estimated tax on the $100,000 of conversion income? Technically, yes. You might need to increase your withholding on other income, or make estimated tax payments, as a result of the conversion.*

But keep in mind that there are a number of important exceptions to the estimated tax payment rules. For example, if your tax withholding for 2015 is at least equal to your 2014 tax liability, you generally would not be required to make estimated tax payments, and you would not be subject to an underpayment penalty, regardless of the amount of your Roth conversion income.

Importance of Timing a Roth IRA Conversion: An Example

Conventional wisdom holds that if you convert a traditional IRA to a Roth IRA, you should never pay the conversion taxes from IRA assets. The reason is that you'll be depleting IRA assets that might otherwise be available to grow on a tax-deferred basis. The withdrawal from a traditional IRA to pay the conversion taxes is also a taxable distribution, generating an additional tax liability, requiring an additional withdrawal, and so on--plus you'll generally pay a 10% penalty if you're not yet 59½.

It's also conventional wisdom that converting a traditional IRA to a Roth IRA is tax neutral so long as income tax rates remain the same at the time of conversion and after retirement.

Conventional wisdom isn't always right

But there's one scenario where conventional wisdom may not apply. This is best explained with an example.[1] Let's assume the following:

1. You'll be 59½ or older as of January 1, 2015, and you've had a Roth IRA for at least five years. So you'll be eligible for tax-free and penalty-free qualified distributions from your Roth IRA in 2015.

2. You've decided that it's appropriate for you to have more retirement assets in a Roth IRA.

3. You own a stock in your traditional IRA that you anticipate could be a candidate for higher-than-average gains. For example, let's assume you own 10,000 shares of Acme Pharmaceuticals, a highly speculative biotech that has a drug pending before the FDA. The shares are currently trading at $10. After diligent research, you've determined that the Acme stock could climb to as much as $50 if the drug is approved by the FDA, but it is equally likely to drop to $1 if not approved. The FDA deadline for approval is October 1, 2015. (For simplicity, we'll assume the Acme stock is the only asset in your traditional IRA and that you are converting the entire IRA.)

4. You want to convert your traditional IRA to a Roth in 2015, before the potential appreciation in Acme stock, but you don't have any cash available to pay the conversion tax, or you simply don't want to pay the conversion tax from other (non-IRA) assets.

Now let's further assume that Acme's drug does receive FDA approval on October 1, 2015, and the stock does in fact jump from $10 to $50.

Result if you do not convert

If you did not convert your traditional IRA to a Roth IRA, your traditional IRA would now hold 10,000 shares of Acme stock worth $500,000. Again, for simplicity, let's assume you sell the stock, your account now holds the $500,000 cash proceeds, and you make no further trades or contributions to the account. Assuming you earn 6% until your retirement in 10 years, your account would grow to approximately $895,000. Assuming a 28% federal income tax rate, the after-tax value of your account would be $644,705 at retirement.

Result if you do convert

Now let's assume you did convert your traditional IRA to a Roth IRA before October 1, 2015. The stock was worth $100,000 at the time of conversion, and assuming a 28% tax rate, the federal income tax is $28,000, due when you file your 2015 tax return. On October 1, when the drug is approved, the value of the shares increases to $500,000. Again, for simplicity, let's assume you sell the stock, your account now holds the $500,000 cash proceeds, and you make no further trades or contributions to the Roth IRA.

On October 1 you also receive a tax-free $28,000 qualified distribution from the Roth IRA to pay the conversion tax (although technically you wouldn't need to actually pay that tax until April 15, 2016).[2] Now your Roth IRA balance is $472,000. Assuming the same 6% earnings rate, after 10 years your IRA would have grown to approximately $845,000--about $200,000 more than if you had not converted--even though tax rates have remained constant and you've paid the conversion tax from IRA assets.

There's no magic to this. You're simply paying--from the Roth IRA--conversion taxes on the stock before the appreciation, instead of paying taxes on the fully appreciated value of the stock in the traditional IRA at retirement. But by paying the conversion tax from the Roth IRA--instead of from the traditional IRA--you're able to convert your entire traditional IRA, keeping the funds in the Roth IRA (and potentially benefitting from the hoped-for appreciation) until you actually make a withdrawal from the Roth IRA to pay the tax.

And you can always recharacterize if things go wrong

But what happens if you turn out to be wrong, the FDA does not approve Acme's drug, and the stock drops to $1? Well, in that case, you can simply undo the conversion. You have until October 15, 2016, to recharacterize the Roth IRA back to a traditional IRA, and for tax purposes you'll be treated as though the conversion never happened (with no resulting tax bill, or a tax refund if you already paid taxes on the conversion).

Before taking any specific action, be sure to consult with your tax professional.

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How can college students save and spend money wisely?

College is a pivotal time in a young adult's life. Students gain a sense of independence that is accompanied by responsibility--especially when it comes to finances. If you're a new college student, it can be overwhelming to figure out how to save and spend money wisely. However, if you take time to plan, you won't have to worry about spending money carelessly. And your parents will be glad to avoid desperate pleas for cash over the phone.

It may be helpful to review campus resources ahead of time so you can eliminate items that you don't necessarily need to bring with you to school. Why bring your car and pay for an expensive parking pass if you can use free public transportation? Similarly, it might make more sense to borrow textbooks from your university's library or rent them rather than fork over the dough to buy pricey books you'll use for a single semester.

Next, establish a monthly budget. Track your expenses for a month to determine where most of your money is going, then look for the areas where you need to reevaluate your spending.

For example, you may be spending too much on take-out when you already have a prepaid meal plan at your school. Take advantage of your plan and put that money toward something else in your budget like clothing or entertainment.

What if you have excess cash? Set aside a few dollars each week to create an emergency fund. Over time, that money could accumulate, and you never know when it might come in handy.

But if you still find yourself strapped for cash, most college campuses offer a variety of part-time jobs that are designed to fit into a student's busy schedule. Ask about a job the next time you go to the gym for a workout or the dining hall for a meal. Or you can use your school's career service website to browse work-study options available on campus. As long as you're aware of what's available to you, you'll be better informed to make wise money decisions, which enables you to focus on making the most of this chapter in your academic career.

I'm having trouble paying my student loans. Do I have any options?

If you or someone you know is having difficulty paying back student loans, consider investigating the government's three income-driven repayment plans. These plans--available for federal student loans, not private loans--are designed to make student loan debt more manageable by reducing your monthly payment.

The first and newest program is called Pay As You Earn (PAYE). Under PAYE, borrowers pay 10% of their discretionary income toward their federal student loans each month, and all remaining debt is generally forgiven after 20 years of timely payments. Your monthly loan payment is based on your income, family size, and state of residence. It is readjusted each year based on these criteria.

The second plan is called Income-Based Repayment (IBR), which is similar to Pay As You Earn. Under IBR, borrowers pay 15% of their discretionary income toward their loans each month, and all remaining debt is generally forgiven after 25 years of payments. (For new borrowers who take out loans after July 1, 2014, the IBR terms are the same as PAYE.)

Both PAYE and IBR have an eligibility requirement before you can enter the plan. The payment that you would be required to make under PAYE or IBR (a technical calculation based on your income and family size) must be less than what you would pay under the government's standard repayment plan, which is a fixed amount over a 10-year term.

The third plan is called Income-Contingent Repayment (ICR). The ICR plan does not have an initial eligibility requirement, so any borrower with eligible loans can make payments under this plan. Under ICR, your payment is equal to the lesser of 20% of your discretionary income or what you would pay under a repayment plan with a fixed payment over a 12-year repayment term. The repayment period is 25 years.

Under all three plans, loans are forgiven after 10 years for those in certain public-service jobs.

The U.S. Department of Education offers a Repayment Estimator calculator on its website www.studentaid.ed.gov that you can use to see whether you qualify for certain plans, and to compare monthly payments and total lifetime costs under different plans.

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Cheap Oil Gets Cheaper

The economic news that everybody is talking about lately is the sudden unexpected drop in oil prices. One type of oil, West Texas Intermediate crude, has fallen from over $140 a barrel in the summer of 2008, and $115 a barrel as recently as June, down to $91, and there is no sign that the decline will stop there.

The price drop seems to be the result of a perfect storm of factors, both on the supply and demand side. On the supply side, U.S. production has risen to the point where only Saudi Arabia extracts more oil from its soil. In the recent past, America's additional production was offset by sharp declines in production caused by the civil war in Libya, plus production declines in Iraq, Nigeria and the Sudan. Those countries are now back in business, adding the production equivalent of 3 million barrels a day, a significant fraction of the 75 million barrels a day of global production.

On the demand side, meanwhile, China's growth has fallen by half, European economies are weakening, and people everywhere are driving more fuel-efficient cars and living in more energy-efficient homes.

As always, a major shift in global economics is producing some winners and losers. American consumers are among the most prominent winners, since they consume more oil and gas per capita than the citizens of any other country. The stiff drop in oil prices this year has resulted in U.S. gasoline prices falling 26¢ to an average of $2.88 per gallon, down from $3.14 a month ago. That's equivalent to a $40-billion tax cut that will benefit the transportation sector, energy-dependent manufacturers and, of course, Americans who drive automobiles.

Lower energy prices are also a boon for countries that import a significant amount of crude, including India, which brings in roughly 85% of its oil, and Japan, which is importing oil again now that its nuclear reactor industry is on hiatus.

Losers? You can expect the major oil companies to report lower profits in the months ahead, and the Russian economy which is heavily dependent on energy exports and already feeling the impact of an impending recession, is being crushed. Surprisingly, some believe the biggest loser is Iran, whose social program spending and high costs of extraction imply a break-even well above today's prices, estimated as high as $130 a barrel.

As mentioned earlier, oil prices could—and probably will—drop further. But don't believe the predictions that have popped up in the newspapers and on the financial TV stations of a new era of oil abundance. Oil prices almost certainly won't fall to pre-2007 prices (around $60 a barrel). Why? According to the International Energy Agency, the capital cost of producing a unit of energy—that is, the cost of finding oil and gas, drilling for it, moving it from the well to the refiner, and refining it have doubled since 2000, and the rise in these costs increases yearly. If oil prices drop much further, shale oil producers in North Dakota and Texas will find it unprofitable to keep drilling.

Another floor under prices is the OPEC cartel, which together supplies about 40 percent of the world's oil. A Bloomberg report noted that OPEC nations—particularly Saudi Arabia—have been surprisingly relaxed about the supply/demand shifts. The cartel nations pumped 30.97 million barrels a day in October, exceeding their collective output target of 30 million barrels for a fifth straight month. However, if oil prices were to dip closer to $80 a barrel, the cartel could well turn down the spigot and change the equation back in favor of higher prices.

What should you do about all this? Enjoy! When was the last time you saw prices fall dramatically on an item that you use every day, and you could hardly function without? Chances are, you've been whacked by higher gas prices a few times in your life; this is your chance to enjoy a different dynamic—while it lasts.

Oh… And don't spend a lot of time worrying about the big oil companies. Somehow they'll manage to muddle through and stay profitable long enough to reap big gains the next time prices jump in the opposite direction.

Relative Prosperity

You might have read that the U.S. investment markets are jittery on the news that Japan has experienced two consecutive quarters of economic decline—the official definition of a recession. But if you turn the news around, it offers us a reminder that, however much we complain about slow-growth recovery from 2008, Americans are actually part of one of the most robust economies in the world.

The statistics tell an interesting story. The U.S. economy is growing at a rate of about 2.95% for the year, which is (as the complainers correctly point out) slightly below its long-term pace. But this doesn't look so bad compared to the 2.16% average growth average for the G7 nations in aggregate, and our growth numbers are well ahead of the European Union, whose economies are expanding at an anemic 1.28% rate this year.

Look deeper and our story looks even better. The current recession is Japan's fourth in six years, despite long-term stimulus efforts that make the Fed's QE program look like a purchase at the candy store. Europe is rumored to be teetering on the edge of recession, which would be its second since the 2008 meltdown. The published GDP figures coming out of China (which are very unreliable due to heavy government editing) could drop to about half the long-term rate this year, and Brazil entered recession territory last summer.

But what about the 5.8% unemployment rate? That's better than the 10% rate at the end of 2008, but it's not good—right? Compared with the rest of the world, America's jobs picture looks downright rosy. The list, below, shows that only 13 countries have lower jobless rates than the American economy, and some of those (Malaysia, Russia, Saudi Arabia) may be giving out numbers that their leaders want to hear. Yes, it would be nice if the long, sustained GDP growth we've enjoyed these last six years were faster, and we all hope that the unemployment rate continues dropping. But compared with just about everywhere else, life in the U.S.—on the economic front, at least—is pretty good

Global unemployment rates

Malaysia (2.7%)
Switzerland (3.1%)
South Korea (3.5%)
Japan (3.6%)
Norway (3.7%)
Taiwan (3.9%)
Denmark (4.0%)
Brazil (4.9%)
Russia (4.9%)
Germany (5.0%)
Mexico (5.1%)
India (5.2%)
Saudi Arabia (5.5%)
UNITED STATES (5.8%)
Indonesia (5.9%)
Pakistan (6.0%)
United Kingdom (6.0%)

Australia (6.2%)
Israel (6.5%)
Canada (6.5%)
Chile (6.6%)
Phillippines (6.7%)
Venezuela (7.0%)
Czech Republic (7.1%)
Argentina (7.5%)
Sweden (7.5%)
Netherlands (8.0%)
Austria (8.1%)
Colombia (8.4%)
Finland (8.5%)
Belgium (8.5%)
Iran (9.5%)
Turkey (10.1%)
France (10.2%)
Ireland (11.0%)
Poland (11.3%)
Egypt (12.3%)
Italy (12.6%)
Portugal (13.1%)
Iraq (15.1%)
Spain (23.7%)
Nigeria (23.9%)
South Africa (25.4%)
Greece (25.9%)

Getting Premium at the Cost of Regular

Whenever we fill up our cars with gas, we have a choice: we can buy "regular," or we can pay extra (sometimes as much as 30 cents a gallon extra) for "premium" gasoline. Many experts say that, for most cars, premium gas doesn't accomplish anything except, perhaps, adding to the bonus pools of oil company executives. That's why thrifty car owners always push the "regular" button on the self-service display.

The bond world uses similar terminology. You can buy a "premium" bond, which means you're paying more than the original offering price -- in other words, more than you'll get back when the bond matures. Or you can buy bonds at par and receive what you invested back at maturity.

For instance, you might see bond tables which show that a newly-issued 5-year bond is selling for $100, so if you invested (to keep the numbers round) $1 million in this bond, you'll get back $1 million at the end of five years, plus five annual coupon payments at the bond's interest rate. Another bond with a 5-year maturity, with the same face amount of $100, is being sold for $109.16. You pay $1,091,600 for the bond and get back $1 million at the end of the term.

Being a thrifty investor, you would be careful only to push the "par" button whenever you buy on the bond market. Right? Unfortunately, bond terminology doesn't always make the kind of common sense we encounter in the real world. The truth is, premium bonds normally cost exactly the same as bonds sold at par.

How is that possible? The difference lies in the amount and timing of the coupon payments. If you take a closer look at those two 5-year bonds, you discover that the one at par is paying interest at today's market rate of 3% (again, keeping the numbers round). The reason investors are willing to pay a "premium" for the second bond is because it's offering a higher coupon of 5%.

How can you compare the two? The par bond will pay you $30,000 (3% of $1 million) for five years, which comes to $150,000. If you were to reinvest the money each year at the same current 3% rate, you'd get an additional $9,274 in interest. Add the coupon payments and the reinvestment amount to the $1 million you get back when the bond matures, and the total comes to $1,159,274.

Now consider the premium bond, where you're paying more than par up-front, enough more so that your $1 million will only buy of $916,091 worth of paper. But each year, you get $45,804 in coupon payments (5% times the face amount), for a total of $229,023. If you reinvest those payments at the current 3% interest rates, you will receive an additional $14,160. Add up $916,092, $229,023 and $14,160 -- and presto-- the total comes to exactly the same $1,159,274 from the par bond. You can see the comparison in the accompanying chart.

Table 1: Cash Return for the 5 Year Par Bond (3% Coupon) @ 3% yield = $100

Year	Coupon	Reinvestment Interest on Coupons	Return of Face Amount	Received
1	$30,000.00			
2	$30,000.00	$900.00		
3	$30,000.00	$1,827.00		
4	$30,000.00	$2,781.81		
5	$30,000.00	$3,765.26	$1,000,000.00	
Total	$150,000.00	$9,274.07	$1,000,000.00	**$1,159,274.07**

Table 2: Cash Return for the 5 Year Premium Bond (5% Coupon) @ 3% yield = $109.16*

Year	Coupon	Reinvestment Interest on Coupons	Return of Face Amount	Received
1	$45,804.57			
2	$45,804.57	$1,374.14		
3	$45,804.57	$2,789.50		
4	$45,804.57	$4,247.32		
5	$45,804.57	$5,748.88	$916,091.39	
Total	$229,022.85	$14,159.83	$916,091.39	**$1,159,274.07**

* Although bond prices are usually rounded off, we use the precise value of $109.1594144 in all our calculations here.

So why would serious bond investors, armed with bond calculators which can tame these numbers down to the penny, buy one or the other? There are two reasons. First, since interest rates have mostly been falling since the early 1980s, most bonds on the market today happen to be premium bonds; that is, they were issued at a time when coupon payments were higher than today's market rate.

The second reason is more interesting. Premium bonds offer an advantage during periods when interest rates are rising--which many people worry about, given today's historically low rates, especially if the Federal Reserve Board decides to stop stimulating the economy at some point in the future.

Remember, the calculations you saw earlier assumed that you would reinvest your coupon payments at a steady 3% rate. If rates in the second year happened to be higher, and still higher in the third and subsequent years, the bottom line for both the par bond and the premium bond will be a bit higher. But the premium bond would outpace the par bond because more money -- the higher coupon payment -- is being reinvested at those higher rates.

The bottom line? Don't be put off by the terminology. A premium bond actually costs the same as a par bond--which is very different from premium gas, or premium seating or a lot of other things where you're paying more for something of dubious additional value. You can buy premium bonds and still be thrifty, and smart, and perhaps even a bit wealthier if interest rates happen to rise in the months and years ahead.